

Boston College Law Review

Volume 55 | Issue 2

Article 3

3-28-2014

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Recommended Citation

Shu-Yi Oei, *Taxing Bankrupts*, 55 B.C.L. Rev. 375 (2014), <http://lawdigitalcommons.bc.edu/bclr/vol55/iss2/3>

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TAXING BANKRUPTS

SHU-YI OEI*

Abstract: When a debtor goes bankrupt and limited assets have to be divided between competing creditors, should unpaid taxes owed to the government be paid before the debts owed to other creditors? This Article defends the notion that some tax debts should be awarded priority. Insofar as bankruptcy protection transfers the risk of financial distress from a debtor to her creditors, the tax priority debate should be understood as a fight about how much debtor default risk the government should have to assume relative to other creditors. This Article argues that the government's share of debtor default risk should be limited through the grant of tax priority because, contrary to the claims of critics, the government is constrained in its ability to diversify against such risk via both substantive tax policy and changes in tax administration. Tax priority therefore serves as an important structural limit on the government's bankruptcy risk burden and safeguards the myriad important functions of government.

INTRODUCTION

What role should the government play in times of economic distress? To what extent should the government offer assistance to financially troubled citizens and businesses, thereby smoothing consumption and absorbing economic shocks? And what form should such intervention, if any, take? These types of questions are at the crux of the ongoing debate over whether unpaid taxes owed to the government should be paid ahead of the debts owed to private creditors when a distressed debtor files for bankruptcy.¹ In principle, awarding such bank-

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* Associate Professor of Law, Tulane Law School. I am grateful to the participants of the 2013 National Tax Association Annual Conference tax panels, the 2013 Southeastern Law Schools Junior-Senior Faculty Workshop, the UC Hastings Faculty Colloquium, the Seattle University School of Law Faculty Workshop Series, the 2013 SEALS Conference, the 2013 Washburn Tax Colloquium, the 2013 Law & Society Association Annual Meeting tax panels, the 2013 Pittsburgh Tax Workshop, the 2013 Tulane Tax Roundtable, the 2012 ClassCrits V Workshop, the 2012 Carter Commission Tax Conference at Dalhousie University Schulich School of Law, and the 2012 Junior Tax Scholars Workshop for their comments and feedback on this project. My particular thanks to Claire Dickerson, Diane Dick, Adam Feibelman, Heather Field, Kristin Hickman, Steve Johnson, Lily Kahng, Marjorie Kornhauser, Leandra Lederman, Stephanie Hunter McMahon, Lori McMillan, Ajay Mehrotra, Jonathan Nash, Steven Sheffrin, and Kirk Stark for their valuable critique of drafts, and to Jacqueline Barber, David Bordson-Bozzo, Caroline Dalla Betta, Christopher Haws, Elizabeth Horn, Keren Kama, James Martin, and Lamar Weeks for outstanding research help. This Article is dedicated to the memory of my mother.

¹ These questions also arise in various other legal contexts, including debates over federal disaster policy, student loan forgiveness, tax forgiveness, and bailouts. See generally Ben Depoorter, *Horizontal Political Externalities: The Supply and Demand of Disaster Management*, 56 DUKE L.J. 101 (2006) (analyzing the dynamics of federal disaster relief through a lens of horizontal political external-

ruptcy “preference” or “priority” to tax debts causes the government to lose less tax revenue when a debtor seeks bankruptcy protection than a rule that treats tax debts on par with general unsecured debts.² Tax priority thus places more risk of debtor default and a greater share of the burden of financing the debtor’s bankruptcy discharge on creditors with lower or no priority.³

This Article defends the preferential treatment accorded to certain tax debts in bankruptcy based on the need to limit the government’s exposure to debtor default risk. As shorthand, and following the bulk of the literature on the subject, this Article refers to such preferential treatment for tax debts as “tax priority,” though the discussion also assumes that such tax debts will often be treated as nondischargeable.⁴ This Article frames the tax priority question as a question of whether and how to limit the government’s overall risk exposure both in and outside of bankruptcy, and suggests that tax priority is defensible in light of the realities of tax policy and tax administration.

The question of how much debtor default risk the government should bear is central to the tax priority question in both consumer and business bankruptcies,⁵ though each type of bankruptcy raises slightly different issues.⁶ Consumer

ities); Adam Feibelman, *Defining the Social Insurance Function of Consumer Bankruptcy*, 13 AM. BANKR. INST. L. REV. 129 (2005) (analyzing consumer bankruptcy as a system of social insurance); Shu-Yi Oei, *Getting More By Asking Less: Justifying and Reforming Tax Law’s Offer-in-Compromise Procedure*, 160 U. PA. L. REV. 1071 (2012) [hereinafter Oei, *Offer-in-Compromise*] (analyzing a program by which the IRS may forgive certain delinquent taxes owed); Shu-Yi Oei, *Who Wins When Uncle Sam Loses? Social Insurance and the Forgiveness of Tax Debts*, 46 U.C. DAVIS L. REV. 421 (2012) [hereinafter Oei, *Social Insurance*] (discussing the social insurance function of tax nonforgiveness programs); Michael Simkovic, *Risk-Based Student Loans*, 70 WASH. & LEE L. REV. 527 (2013) (arguing for risk-based pricing of student loans). It should be noted that some unsecured debts are also held by the government. For example, the U.S. Department of Education extends unsecured loans to help pay for education costs. See *Students*, FED. STUDENT AID, <http://www.direct.ed.gov/student.html>, archived at <http://perma.cc/G9LW-7V2C> (last updated Jan. 3, 2014).

² See *infra* notes 25–52 and accompanying text (describing priority generally and by example). This is because priority debts must be fully paid before unsecured and lower-priority debts are paid. See, e.g., 11 U.S.C. § 726(a) (2012); see also *id.* § 507 (listing the types of claims that receive priority under the bankruptcy code). How much the government actually collects will depend on whether there are assets remaining after secured and higher-priority debts have been paid, and whether it is successful in collecting nondischargeable debts after the bankruptcy is concluded.

³ See generally *infra* notes 163–209 and accompanying text (describing absorption of debtor default risk by the government and other creditors).

⁴ As explained further in Part I, Section C, nondischargeability is a design feature primarily of Chapter 7 liquidation bankruptcies, Chapter 13 bankruptcies, and individual Chapter 11 bankruptcies. See *infra* notes 75–91 and accompanying text. Nondischargeability does not apply in business Chapter 11 filings. See 11 U.S.C. § 727(a)(1) (2012) (barring discharge for non-individual debtors). Thus, nondischargeability must be analyzed alongside priority to achieve a complete understanding of the bankruptcy distributive scheme.

⁵ See *infra* notes 92–162 and accompanying text (describing policy arguments for and against tax priority).

⁶ Much of bankruptcy scholarship has treated consumer and business bankruptcies as analytically distinct. See, e.g., Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 816 (1987) (discussing bankruptcy policy in the context of business

bankruptcy is often characterized as a system of social insurance against financial distress in the sense that it transfers debtor default risk to creditors in exchange for higher ex ante interest rates and/or tighter lending standards than if bankruptcy did not exist.⁷ Thus, the tax priority question in the consumer bankruptcy context is essentially a question of how much of the burden of providing social insurance the government should bear, as compared to general creditors (with tax priority effectively meaning a smaller social insurance burden on the government). In business bankruptcy cases, the social insurance frame has been less frequently invoked.⁸ Nevertheless, the role of government in insuring against economic shocks has in recent years increasingly been extended to businesses as well as consumers.⁹ Furthermore, from a tax policy and government

failures); Richard M. Hynes, *Why (Consumer) Bankruptcy?*, 56 ALA. L. REV. 121, 123 (2004) (noting that “the purposes assigned to bankruptcy in the debate over business bankruptcy do not readily apply to our current system of consumer bankruptcy”); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 341 (1993) [hereinafter Warren, *Imperfect World*] (limiting a policy discussion to business bankruptcies); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 776–77 (1987) [hereinafter Warren, *Bankruptcy Policy*] (limiting a debate with Professor Douglas Baird over bankruptcy policy to the business bankruptcy context). Yet, because the government’s ability to manage debtor default risk is important in both types of bankruptcies, it is appropriate in the tax priority context to address both under a unified framework, while pointing out differences between each context where appropriate.

⁷ Jean Braucher, *Consumer Bankruptcy as Part of the Social Safety Net: Fresh Start or Treadmill?*, 44 SANTA CLARA L. REV. 1065, 1072–73 (2004) (characterizing bankruptcy as stemming from incomplete public and private insurance coverage for the middle class); Feibelman, *supra* note 1, at 129 (“Bankruptcy scholars generally agree that consumer bankruptcy functions, at least in part, as a form of social insurance.”); Charles G. Hallinan, *The “Fresh Start” Policy in Consumer Bankruptcy: A Historical Inventory and an Interpretive Theory*, 21 U. RICH. L. REV. 49, 100 (1986) (noting that bankruptcy “provides the debtor with credit insurance coverage in an amount equal to his dischargeable liabilities less his nonexempt assets at bankruptcy”); Richard M. Hynes, *Non-Procrustean Bankruptcy*, 2004 U. ILL. L. REV. 301, 350–59 (comparing debt relief to other forms of social insurance); Hynes, *supra* note 6, at 153 (“[T]he most plausible justification for the bankruptcy discharge is that it provides the consumer with a form of insurance that the consumer failed to purchase due to some form of market failure.”); Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 307 (1995) (characterizing bankruptcy law as “social insurance for the nonpoor”).

⁸ Business bankruptcy scholarship has tended to focus on how losses should be distributed among creditors given an insufficient asset pool. *See, e.g.*, THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 8 (1986) [hereinafter JACKSON, *LOGIC AND LIMITS*] (describing bankruptcy law as stemming from the effect of an insolvent debtor’s “obligation to repay creditor A on its remaining creditors”); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain*, 91 YALE L.J. 857, 857 (1982) [hereinafter Jackson, *Creditors’ Bargain*] (noting that business bankruptcy is “concerned with creditor-distribution questions”); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 721 (1991) (offering a “value-based account” of bankruptcy as a response to diverse aspects of financial distress); Warren, *Bankruptcy Policy*, *supra* note 6, at 785 (“In bankruptcy, with an inadequate pie to divide and the looming discharge of unpaid debts, the disputes center on who is entitled to shares of the debtor’s assets and how these shares are to be divided.”).

⁹ *See, e.g.*, Cheryl D. Block, *Measuring the True Cost of Government Bailout*, 88 WASH. U. L. REV. 149, 197–98 (2010); Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L.J. 951, 984–90 (1992) (discussing the use of an insurance model to allocate the risk

expenditures perspective, there has never been a completely binary divide between consumers and businesses because it is recognized that a single individual or entity may engage in both consumption and production behaviors.¹⁰ Thus, the question of whether the government's exposure to debtor default risk should be limited through tax priority is also present in business bankruptcy cases.

This Article argues that tax priority plays the important function of limiting the government's exposure to debtor default risk both in bankruptcy and outside of bankruptcy. The government's risk burden in bankruptcy cannot be viewed in isolation because, unlike general creditors, the government's risk burden impacts various important societal and economic functions that government is required to perform outside of bankruptcy. Such functions include national defense, the provision of public goods, and the administration of the social safety net through nonbankruptcy avenues. In sum, any policy that increases the government's share of debtor default risk in bankruptcy must consider the impacts on these other government functions.

Critics of tax priority tend to assume that increasing the government's debtor default risk burden in bankruptcy will not present problems for other government functions because the government is well equipped to protect itself and is better at managing risk than private creditors.¹¹ Thus, they argue that eliminating tax priority would present no downside to the government while having the desirable effect of reducing the risk exposure of private creditors, thereby lowering the ex ante costs of credit.¹² This Article shows, however, that the government's ability to diversify against risk is more limited than priority's critics imagine. In particular, elimination of tax priority is likely to affect the nonbankruptcy behaviors of debtors, other creditors, and the government itself in ways that may further increase the government's risk exposure both in and prior to bankruptcy. These points have not been sufficiently appreciated in the tax priority literature. Because the government's ability to diversify against debtor default risk is limited and is likely to give rise to distributive consequences, eliminating tax priority is likely to have a significant impact on other government functions.

The tax priority question explored in this Article is not new but is worth revisiting at this time.¹³ Although U.S. law still awards priority to certain tax debts,

of loss of bailouts and discussing bankruptcy as an alternative to bailouts); Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 473, 483–89 (2011) (discussing insurance schemes as a way to cope with the failure of “too big to fail” firms); David Zaring, *The Post-Crisis and Its Critics*, 12 U. PA. J. BUS. L. 1169, 1169–73 (2010) (discussing and justifying the government's role in financial crisis management).

¹⁰ Cf. *infra* notes 204–206 and accompanying text (describing fuzzy legal distinctions between commercially active entities).

¹¹ See *infra* notes 119–156 and accompanying text.

¹² See *infra* notes 119–156 and accompanying text.

¹³ See, e.g., F.H. Buckley, *The Bankruptcy Priority Puzzle*, 72 VA. L. REV. 1393, 1412–16 (1986); William T. Plumb, Jr., *The Federal Priority in Insolvency: Proposals for Reform*, 70 MICH. L. REV. 3,

in the last two decades, various U.S. and foreign commentators, international bodies, and study commissions have advocated the reduction or elimination of tax priorities in the context of business insolvencies.¹⁴ Some countries, such as Austria and Germany, have repealed priorities altogether, while others, such as Australia and the United Kingdom, have eliminated priority for tax debts.¹⁵ Against this backdrop, the role of government in providing public goods, smoothing economic shocks, and administering the social safety net has evolved, and has arguably increased.¹⁶ Most pertinently, in light of the 2008 financial crisis, the question of the appropriate scope of government intervention when crisis strikes has gained increasing visibility at the same time that the adequacy of government revenues has come into serious question.¹⁷ In light of these devel-

54–56 (1971) [hereinafter Plumb, *Federal Priority in Insolvency*]; William T. Plumb, Jr., *Federal Liens and Priorities—Agenda for the Next Decade*, 77 YALE L.J. 228, 244 (1967) [hereinafter Plumb, *Agenda for the Next Decade*] (noting that priority “discourage[s] uninsured credit by making it more hazardous”); Harold Wurzel, *Taxation During Bankruptcy Liquidation*, 55 HARV. L. REV. 1141, 1141 (1942).

¹⁴ See, e.g., Barbara K. Day, *Governmental Tax Priorities in Bankruptcy Proceedings: An International Comparison*, 15 J. BANKR. L. & PRAC. 565, 566–68 (2006) (describing the policy debate over priorities); Barbara K. Morgan, *Should the Sovereign Be Paid First? A Comparative International Analysis of the Priority for Tax Claims in Bankruptcy*, 74 AM. BANKR. L.J. 461, 465–69 (2000) (describing criticisms of priority rules and corresponding reforms); Jack F. Williams, *Rethinking Bankruptcy and Tax Policy*, 3 AM. BANKR. INST. L. REV. 153, 203–05 (1995) [hereinafter Williams, *Rethinking Bankruptcy and Tax Policy*] (citing JAMES A. MACLACHLAN, HANDBOOK OF THE LAW OF BANKRUPTCY 145–54 (1956)); Jack F. Williams, *National Bankruptcy Review Commission Tax Recommendations: Individual Debtors, Priorities, and Discharge*, 14 BANKR. DEV. J. 1, 50–52 (1997) [hereinafter Williams, *NBRC Tax Recommendations*] (citing Harold Marsh, Jr., *Triumph or Tragedy? The Bankruptcy Act Amendments of 1966*, 42 WASH. L. REV. 681, 729 (1967)); Rocio Albert López-Ibor & Joaquín Artés-Caselles, *Bankruptcy Proceedings and Government: Should Bankruptcy Law Grant Privileges to the Treasury?* 15–16 (Ger. Working Papers in Law & Econ., Paper No. 9, 2003), available at <http://www.bepress.com/cgi/viewcontent.cgi?article=1060&context=gwp>, archived at <http://perma.cc/F7B9-B5CA> (concluding that the government should be treated as an ordinary creditor for efficiency reasons); see also *infra* notes 123–129 and accompanying text (describing the positions taken by certain international organizations).

¹⁵ See *Australia Corporations Act 2001* (Cth) ss 555–563AAA; INSOLVENZRECHTSÄNDERUNGSGESETZ 2010 [IRÄG 2010] [Insolvency Law Amendment Act 2010] BGBl. I No. 29/2010 (Austria); Insolvenzordnung [InsO] [Insolvency Act], Oct. 5, 1994, BGBl. I at 2866, last amended by Gesetz [G], Dec. 20, 2011, BGBl. I at 2854 (Ger.), available at http://www.insol-europe.org/download/file_7235, archived at <http://perma.cc/Z22N-23UE>; Enterprise Act of 2002, c. 40, § 251, (Gr. Brit.). See generally Christopher F. Symes, *Reinventing the Taxation Priorities in Insolvency*, 1 J. AUSTRAL-ASIAN TAX TEACHERS ASS’N 435 (2005) (discussing the elimination of tax priorities in the United Kingdom and Australia); Daniel Durrschmidt, *Abolition of Tax Priorities in Germany: A Myth?*, 2 INT’L CORP. RESCUE 227 (2005) (discussing repeal of priorities in Germany’s Insolvenzordnung).

¹⁶ See, e.g., Oei, *Offer-in-Compromise*, *supra* note 1, at 1100–16 (describing the evolution of an IRS procedure to forgive debt); Zaring, *supra* note 9, at 1170 (noting the government’s involuntary role in facilitating post-crisis insolvencies).

¹⁷ See *infra* notes 200–203 and accompanying text (discussing why the government’s debtor default risk must be analyzed in light of its social insurance functions). For example, tax evasion and inadequate tax revenues was one of the causes of the 2009–2010 Greek sovereign debt crisis. See, e.g., Landon Thomas Jr. & Eleni Varvitsioti, *Greek Tax Crackdown Yields Little Revenue in Tackling the*

opments, the long-debated question of tax priority deserves renewed attention and reconsideration.

Part I describes the current bankruptcy treatment of tax debts, explaining tax priority and discussing how tax priority interacts with security interests and the bankruptcy discharge.¹⁸ Part II outlines the debate over tax priority and shows that the arguments against tax priority are grounded upon two normative underpinnings: first, that tax priority is inefficient; and second, that the government can diversify against increased debtor default risk from tax priority's elimination through adjustments in substantive tax policy and tax administration.¹⁹ Having summarized current law and the state of the tax priority debate, Parts III through V defend tax priority. Part III argues that the amount of debtor default risk borne by the government in bankruptcy necessarily impacts its ability to carry out nonbankruptcy risk-bearing and public provision functions, and that the government's risk exposure in bankruptcy should therefore be circumscribed.²⁰ Parts IV and V argue that the government's ability to diversify against debtor default risk using substantive tax policy or tax administration tools is subject to a number of important constraints and is more limited than priority's critics imagine.²¹

This Article ultimately concludes that, viewed from a unified perspective that takes into account both the pre- and postbankruptcy incentives of debtors, private creditors, and the government, a rule allowing tax priority is probably the better rule. Such a rule is most likely to facilitate an optimal role for government in providing public goods, absorbing economic shocks, and providing social insurance in times of financial distress, both during bankruptcy and in bankruptcy's shadow.

Three initial caveats are in order. First, this Article's focus is on U.S. tax and bankruptcy law. An act of translation will be required in order to extend the analysis to other countries. Second, the defense of tax priority presented here is necessarily uneasy because more empirical work needs to be done to ascertain the precise impact of priority's removal both in and outside of bankruptcy. Yet even in the absence of empirical data, it is clear that tax priority's critics have not fully appreciated the realities of tax policymaking and tax administration in assessing the government's ability to manage debtor default risk. Finally, this Article has deliberately chosen to address the tax priority question in business and consumer bankruptcies under a unified framework. This move is contrary to the approach of much of the bankruptcy literature, but is appropriate in the tax prior-

Deficit, N.Y. TIMES, May 12, 2013, at B2 (linking inadequate tax revenue to Greece's near-collapse during and after the financial crisis).

¹⁸ See *infra* notes 22–91 and accompanying text.

¹⁹ See *infra* notes 92–162 and accompanying text.

²⁰ See *infra* notes 163–209 and accompanying text.

²¹ See *infra* notes 210–341 and accompanying text.

ity context because many of the same issues arise in both types of bankruptcy, and also because the tax revenues end up in the same place. This Article will note the material divergences between the consumer and business bankruptcy frameworks in places where they arise.

I. THE BANKRUPTCY DISTRIBUTIVE SCHEME: PRIORITY, SECURITY, AND DISCHARGE

This Part describes the bankruptcy distributive scheme. Section A explains bankruptcy priority and describes the specific rules under U.S. law regarding the award of priority to tax claims.²² Section B then discusses security.²³ Finally, Section C explains the bankruptcy discharge.²⁴ Security and discharge are important features of bankruptcy that are crucial for a complete understanding of how the value of the bankruptcy estate is distributed.

A. Priority

Generally speaking, in a liquidation bankruptcy, if a debt owed to a certain creditor has bankruptcy priority, this debt must be paid off in its entirety before nonpriority unsecured debts and debts of a lower priority are paid.²⁵ In Chapter 11 and 13 reorganization bankruptcies, the rule is full payment of priority tax debts over a certain time period, subject to certain exceptions.²⁶ Thus, the priority creditor is awarded a larger slice of the bankruptcy pie at the expense of unsecured and lower priority creditors. In terms of bankruptcy structure, the priority concept is a deviation from the notion of equality among creditors.²⁷

1. A Simple Example

The priority concept as it plays out in a liquidation bankruptcy can be illustrated using a simple example: Imagine a debtor, Dan, who owes \$10,000 to the IRS, \$10,000 to his Aunt Christine, \$10,000 in medical bills, and \$10,000 to his credit card lender. Dan has total assets of only \$10,000 and very modest prospects for future income and is thus unable to pay these debts. He files for Chap-

²² See *infra* notes 25–52 and accompanying text.

²³ See *infra* notes 53–74 and accompanying text.

²⁴ See *infra* notes 75–91 and accompanying text.

²⁵ See 11 U.S.C. § 726(a) (2012); Warren, *Bankruptcy Policy*, *supra* note 6, at 789 (“A priority payment to one unsecured creditor necessarily leaves less for the remaining creditors.”).

²⁶ See 11 U.S.C. § 1129(a)(9)(C)(iii) (guaranteeing that tax priority creditors receive more favorable treatment than general unsecured creditors); *id.* § 1322(a)(2), (d) (guaranteeing full payment of priority claims in Chapter 13, unless declined by creditors).

²⁷ See *Cunningham v. Brown*, 265 U.S. 1, 13 (1924) (“[E]quality is equity, and this is the spirit of the bankrupt law.”); Yaad Rotem, *Pursuing Preservation of Pre-Bankruptcy Entitlements: Corporate Bankruptcy Law’s Self-Executing Mechanisms*, 5 BERKELEY BUS. L.J. 79, 92–95 (2008) (discussing the “equality as equity” principle and its exceptions).

ter 7 bankruptcy protection in order to liquidate his assets and obtain a discharge of his debts and a fresh financial start. In this case, the tax priority question is about whether the \$10,000 that Dan owes the IRS should be paid first in the bankruptcy, ahead of the debts owed to Aunt Christine, the medical provider, and the credit card company. Assuming that there are no administrative expenses and that Dan's \$10,000 of assets is not exempt from creditor taking, granting the IRS's tax claim such priority over the other debts would effectively mean that all \$10,000 of Dan's assets would go to the IRS, leaving the other creditors with nothing.²⁸ In contrast, in the absence of any priorities, each creditor would receive a \$2500 distribution, and the remaining \$7500 owed to each would go unpaid and—absent an exemption from discharge—would be discharged at the end of the bankruptcy.²⁹

This simplified example illustrates the type of common pool problem³⁰ that bankruptcy is designed to solve and the complexity of the decision whether to award tax priority.³¹ Allowing the tax creditor to jump ahead of other creditors may prevent nonpriority and lower-priority creditors from receiving any distribution in a liquidation bankruptcy where the debtor has insufficient assets for distribution after the tax claim has been paid. This may lead such creditors to become less willing to lend in the face of bankruptcy risk and may reduce the availability of credit in the economy. On the other hand, if bankruptcy law does not award tax priority, this could lead to inequities in tax enforcement, whereby compliant taxpayers pay their full tax bills but financially distressed taxpayers can avoid doing so by filing for bankruptcy protection. Such inequity may lead to erosion of morale among taxpayers and ultimately to revenue drain.³²

2. Tax Priority Under U.S. Bankruptcy Law

As might be expected, the actual rules governing tax priorities under U.S. bankruptcy law are more complex. 11 U.S.C. § 507(a) provides a ranked list of ten types of allowed unsecured claims that are entitled to priority over other unsecured claims.³³ Most types of tax debts that have priority are listed in the

²⁸ See 11 U.S.C. § 507 (listing the priority claims); *id.* § 726(a)(1) (describing order of payment of claims); *see also id.* § 503(b) (describing administrative expenses).

²⁹ See *id.* § 727 (describing discharge in Chapter 7); *id.* § 523 (listing exceptions to discharge).

³⁰ See JACKSON, LOGIC AND LIMITS, *supra* note 8, at 11 (citing Alan E. Friedman, *The Economics of the Common Pool: Property Rights in Exhaustible Resources*, 18 UCLAL. REV. 855, 855 (1971)) (characterizing bankruptcy as "a species of what is called a *common pool* problem").

³¹ Although the procedures in reorganization bankruptcies are slightly different from the liquidation scenario presented above, the value allocation issues presented are similar. See 11 U.S.C. § 1129 (listing the requirements for confirmation of a reorganization plan).

³² See *infra* notes 332–334 and accompanying text (discussing the impact of priority on taxpayer morale).

³³ 11 U.S.C. § 507(a)(1)–(10). It should be noted that these priority provisions only provide for priority of certain unsecured claims over the rights of other unsecured creditors; they do not affect the

eighth priority position.³⁴ This means that the claims listed in the first seven positions of priority, which include domestic support obligations, certain administrative expenses of the bankruptcy estate, and certain claims for wages, salaries, and commissions, must be paid off before the eighth priority taxes are paid.³⁵

The § 507(a)(8) priority taxes include a number of different taxes.³⁶ Most pertinently, the eighth priority taxes generally include income taxes for prebankruptcy tax years for which the tax return was last due (including extensions) after three years before the bankruptcy petition filing date, or for which the tax was assessed within 240 days before the petition date.³⁷ They also generally include trust fund taxes that the debtor is required to collect or withhold and pay over to the government (such as income taxes an employer is required to withhold), property taxes incurred before the bankruptcy and last payable without penalty after one year before the bankruptcy filing date, certain employment taxes paid on priority wage and salary claims for which a return was last due after three years before the bankruptcy filing, penalties related to priority taxes (if such penalties are to compensate for actual pecuniary losses), and certain other taxes.³⁸ It is clear from this description that an important policy behind these tax priorities is to give priority to those taxes that are new enough that the IRS or state revenue authorities may not yet have had an opportunity to collect them

rights of holders of secured claims. 4 COLLIER ON BANKRUPTCY ¶ 507.02[4][b] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2013).

³⁴ 11 U.S.C. § 507(a)(8).

³⁵ See *id.* § 726(a)(1). The way priority claims are ranked means that claims in the first priority position must be fully paid before claims in the second position can be paid, and so on. See *id.*

³⁶ *Id.* § 507(a)(8).

³⁷ *Id.* § 507(a)(8)(A)(i), (ii). The 240 days includes any time during which an offer-in-compromise with respect to the tax was pending or in effect during that 240-day period, plus 30 days; and any time during which a stay of proceedings against collections was in effect in a prior bankruptcy case during that 240-day period, plus 90 days. *Id.* Priority income taxes also include income taxes for prebankruptcy tax years that were not assessed before, but are assessable after, the commencement of bankruptcy proceedings (other than taxes for which the tax return was not filed or filed late within two years prior to the bankruptcy filing, and taxes the taxpayer willfully or fraudulently tried to evade). *Id.* § 507(a)(8)(A)(iii). But see Gregory Germain, *Discharging Income Tax Liabilities in Bankruptcy, A Challenge to the New Theory of Strict Construction for Scrivener's Errors*, 75 UMKC L. REV. 741, 744–45 (2007) (arguing that Congress may inadvertently have combined the look-back and 240-day rules).

³⁸ 11 U.S.C. § 507(a)(8). Other eighth priority taxes are: (1) Excise taxes on transactions occurring before bankruptcy (i) for which a return is last due within the three years before the filing of the bankruptcy petition, or, (ii) if no return is due, for a transaction occurring in the three years before the bankruptcy filing; and (2) certain customs duties arising out of the importation of merchandise, if the merchandise (i) is entered for consumption in the year before the date of the bankruptcy filing, (ii) is covered by an entry liquidated or reliquidated within one year of the bankruptcy filing, or (iii) is entered for consumption in the four years before the bankruptcy filing but is unliquidated on that date, if the Treasury Secretary certifies that the failure to certify was due to certain listed circumstances. *Id.*

and to taxes that a bankrupt debtor collects and holds in trust for another taxpayer.³⁹

Not all taxes, though, are § 507(a)(8) priority taxes. The eighth priority taxes are unsecured claims; in contrast, as discussed in Part I, Section B, some tax claims are secured claims, which are treated differently.⁴⁰ Furthermore, certain taxes are administrative expenses incurred by the bankruptcy estate, which are entitled to second priority position.⁴¹ This means that such administrative expense taxes will be paid after those claims in the first priority position and will rank ahead of the eighth priority taxes.

Because of the way the Bankruptcy Code is structured, the § 507(a) ranking of priorities applies in both business and consumer bankruptcies,⁴² though its impact and significance varies across the different types of proceedings. In a Chapter 7 bankruptcy, which is a procedure by which an entity or an individual debtor's assets are liquidated, the priority taxes will be paid out of the bankruptcy estate after the claims of secured creditors and higher-priority unsecured claims have been paid.⁴³ In a Chapter 13 bankruptcy, in which an individual consumer may undergo financial reorganization by entering into a payment plan, the plan must provide for full payment of all § 507 priority claims, unless the claimholder agrees to a different treatment.⁴⁴ Any unpaid § 507(a)(2) administra-

³⁹ See 4 COLLIER ON BANKRUPTCY, *supra* note 33, ¶ 507[1][b]. But see *id.* ¶ 507.11[2][c][ii] (noting that § 507(a)(8) may provide other bases for priority for older tax obligations). In conformity with this general policy, § 507(a)(8) suspends the time periods listed therein for (1) periods where the government is prohibited by nonbankruptcy law from collecting taxes due to a debtor's request for a hearing and appeal of any proposed or actual collection action, plus 90 days, and (2) periods where collections proceedings were stayed as a result of a former bankruptcy filing. See 11 U.S.C. § 507(a)(8). See generally Gregory Germain, *Income Tax Claims in the Year of Bankruptcy: A Congressionally Created Quagmire*, 59 TAX LAW. 329 (2006) (discussing the treatment of tax claims incurred in the year bankruptcy is filed).

⁴⁰ 11 U.S.C. § 507(a)(8); see *infra* notes 56–69 and accompanying text.

⁴¹ 11 U.S.C. § 503(b)(1)(B) (identifying certain taxes as administrative expenses); *id.* § 507(a)(2) (priority of administrative expenses).

⁴² See *id.* § 103(a) (indicating that the provisions in Chapter 5 of Title 11 apply to all types of bankruptcies, unless provided).

⁴³ See *id.* § 506 (pertaining to determination of secured status); *id.* § 726(a) (listing order of distribution of property of the bankruptcy estate). See generally Dalié Jiménez, *The Distribution of Assets in Consumer Chapter 7 Bankruptcy Cases*, 83 AM. BANKR. L.J. 795, 797, 803 (2009) (finding that only seven percent of bankruptcy cases had assets for distribution and that fifteen percent of those "asset cases" involved priority tax claims). For a general description of the treatment and payment of tax claims in bankruptcy, see DEP'T OF THE TREASURY, INTERNAL REVENUE SERV., PUB. NO. 908, BANKRUPTCY TAX GUIDE 24–25 (rev. Oct. 2012), available at <http://www.irs.gov/pub/irs-pdf/p908.pdf>, archived at <http://perma.cc/GZU8-GLNA>.

⁴⁴ 11 U.S.C. § 1322(a)(2). Deferred cash payments are permitted. *Id.* All plan payments must generally occur within five years, but the period of the plan may be limited to three years in the case of certain lower income individuals. See *id.* § 1322(d). See generally Katherine Porter, *The Pretend Solution: An Empirical Study of Bankruptcy Outcomes*, 90 TEX. L. REV. 103, 133 n.143 (2011) (noting that less than half of Chapter 13 debtors owed tax debts).

tive expense tax claims must be paid before payments to creditors under a Chapter 13 plan may be made.⁴⁵

In Chapter 11 reorganizations,⁴⁶ the plan of reorganization must meet certain specific requirements with respect to the priority taxes in order to be confirmed.⁴⁷ For example, the plan must provide with respect to the eighth priority taxes that the government will receive regular cash installment payments equal to the allowed amount of the priority tax claim over a period ending no later than five years after the date of the order for relief (the bankruptcy petition date in voluntary cases), unless the tax creditor has agreed to a different treatment.⁴⁸ The treatment of these eighth priority taxes must generally not be less favorable than the most favored nonpriority unsecured claim provided for by the plan.⁴⁹ With respect to § 507(a)(2) administrative expense tax claims, the plan must provide for the tax creditor to receive cash equal to the allowed amount of such claim, unless the tax creditor has agreed to a different treatment.⁵⁰ These requirements for plan confirmation must be met even if not all impaired classes have accepted the plan and the plan needs to be “crammed down” over the objections of such creditors.⁵¹ Finally, the priority provisions also interact differently with the discharge provisions in each of these bankruptcy chapters.⁵²

B. Security

In addition to priority, there are two other key concepts—security and discharge—that round out the bankruptcy distributive scheme. Generally speaking, secured claims are claims for which the creditor has the right to look to the underlying property to enforce payment of the claim.⁵³ A secured creditor is generally entitled to the value of its collateral and gets paid first with respect to an as-

⁴⁵ 11 U.S.C. § 1326(b).

⁴⁶ See generally Douglas Baird et al., *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study* (Yale Univ. Int’l Ctr. For Fin., Working Paper No. 05-29, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=866865, archived at <http://perma.cc/EUW8-GDXD> (finding that whereas for businesses with more than \$5 million in assets, priority taxes constituted only 2.1% of all debt, “[s]ecured claims, priority tax claims, and the costs of the bankruptcy process exhaust the estate in the typical case when the business has fewer than \$200,000 in assets”). Chapter 11 bankruptcy is sometimes, though not often, used by individuals. See Bruce A. Markell, *The Sub Rosa Subchapter: Individual Debtors in Chapter 11 After BAPCA*, 2007 U. ILL. L. REV. 67, 69, 92.

⁴⁷ See 11 U.S.C. § 1129(a)(9)(C). These requirements with respect to priority taxes are merely a few of the many requirements for plan confirmation. See *id.* § 1129.

⁴⁸ *Id.* § 1129(a)(9)(C).

⁴⁹ *Id.*

⁵⁰ *Id.* § 1129(a)(9)(A).

⁵¹ *Id.* § 1129(b)(1). An impaired creditor is, generally, one whose legal rights (such as a right to payment) are altered, unless the creditor is fully compensated as required by the statute. *Id.* § 1124.

⁵² See *infra* notes 75–91 and accompanying text (describing interaction of discharge and priority provisions of the bankruptcy code).

⁵³ See 11 U.S.C. § 506.

set in which it has a security interest.⁵⁴ The § 507(a) priorities generally come into play after the secured debts have been paid.⁵⁵

Secured tax claims are treated differently from secured non-tax claims. Federal tax claims are secured by virtue of a statutory lien on the debtor's property.⁵⁶ The significance of secured status for a tax claim differs depending on the bankruptcy chapter. In a Chapter 7 liquidation, property subject to a tax lien is paid off in the following order: first, to lienholders senior to the tax lien;⁵⁷ second, to creditors in the first seven priority positions in § 507(a), up to the value of the secured tax claim;⁵⁸ third, to the tax lien holder, to the extent the secured tax claim exceeds distributions to the 11 U.S.C. § 507(a)(1)–(7) creditors; fourth, to lienholders junior to the tax lien; and finally, to the tax lienholder to the extent the allowed tax claim was not paid in the third position above. Any remaining property subject to the tax lien is paid to the estate.⁵⁹ The positioning of the secured tax claim after the § 507(a)(1)–(7) priority claims may reflect a policy decision to ensure that the secured tax claim does not wipe out these priority claims (which include administrative estate claims, employee unpaid wage claims, alimony and child support claims, and claims for employee benefit plan contributions).⁶⁰

In a Chapter 13 bankruptcy, the plan must pay the secured tax creditor the full value of the secured tax claim, plus interest; this can be done by distributing

⁵⁴ See *id.* § 506(a).

⁵⁵ See *id.* § 507.

⁵⁶ See 26 U.S.C. § 6321 (2012). In the case of federal taxes, the lien arises by operation of law upon the debtor's failure or refusal to pay the tax upon demand. *Id.* The federal tax lien arises at the time of assessment and continues until the tax debt is satisfied or becomes unenforceable due to lapse of time. *Id.* § 6322. Although the federal tax lien arises automatically and by statute, the secured tax claim will generally only become enforceable against certain other creditors if the IRS files a Notice of Federal Tax Lien ("NFTL") prior to the bankruptcy petition date, to the extent of equity in the lien assets. *Id.* § 6323; see *id.* § 6321. The procedure by which state taxing authorities obtain tax liens depends on the law of the state. See, e.g., MASS. GEN. LAWS ch. 60, § 37 (2012) (describing the Massachusetts state procedure for taking tax liens).

⁵⁷ 11 U.S.C. § 724(b).

⁵⁸ *Id.* § 724(b)(2). Note that the amount to which the § 507(a)(1)–(7) claims are entitled is limited to the amount of the secured tax claim. *Id.* The National Bankruptcy Review Commission ("NBRC"), established by the Bankruptcy Reform Act of 1994 to study the Bankruptcy Code, examined the question of how tax liens are treated in bankruptcy and discussed the positions of various stakeholders on whether this "7.5" priority for tax claims is justified. See Williams, *NBRC Tax Recommendations*, *supra* note 14, at 41–42. See generally Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (codified as amended in scattered sections of 11 U.S.C.). The NBRC working group ultimately did not recommend a full repeal of the § 724(b) subordination provisions, but did recommend certain exceptions and limitations to those provisions. Williams, *NBRC Tax Recommendations*, *supra* note 14, at 42.

⁵⁹ 11 U.S.C. § 724(b).

⁶⁰ See AM. BAR ASSOC., EFFECTIVELY REPRESENTING YOUR CLIENT BEFORE THE IRS ¶ 21.1.4.1.2 (Keith Fogg ed., 2011). I examine the policy rationales for the subordination of the tax lien outside of the bankruptcy context in other work. See Shu-Yi Oei, *The Uneasy Case Against Tax Lien Subordination*, 11 PITT. TAX REV. (forthcoming 2014) (on file with author).

the property to the secured creditor or retaining the property and paying the secured claim in full pursuant to the Chapter 13 plan.⁶¹

In Chapter 11 reorganizations, a secured tax claim, along with the priority claims, must generally be paid ahead of the general unsecured claims.⁶² The bankruptcy trustee may not avoid properly filed and perfected secured tax claims.⁶³ Generally, a secured claim (including the tax claim) is entitled to distribution of the collateral or the collateral's fair value.⁶⁴ Nevertheless, this treatment may be modified in the process of confirming the Chapter 11 plan of reorganization: the Chapter 11 plan must group creditors' claims into classes, placing substantially similar claims in each class, and must provide the same treatment for claims grouped into the same class unless a claimholder has agreed to less favorable treatment.⁶⁵ The plan must also specify which classes of claims are and are not impaired.⁶⁶ The secured tax claim will almost always be impaired.⁶⁷ An impaired class is generally considered to accept the reorganization plan only if creditors holding at least two thirds in amount and more than half in number of the allowed claims in the class have accepted the plan.⁶⁸ Still, even if an impaired class of creditors votes against the plan of reorganization, the plan can still be "crammed down" on such creditors and confirmed if the other requirements of plan confirmation and certain other conditions are met.⁶⁹

In sum, commercial and bankruptcy law have long recognized the right of secured creditors to look to the underlying collateral for repayment.⁷⁰ Further-

⁶¹ 11 U.S.C. § 1325(a)(5); see AM. BAR ASSOC., *supra* note 60, ¶ 21.1.4.2.1.

⁶² See 11 U.S.C. § 1129(a)(9).

⁶³ *Id.* § 1129(b)(1) (requiring the confirmation of plans that meet organizational requirements); *id.* § 545(2) (allowing the trustee to avoid unperfected and unenforceable liens); see C. RICHARD MCQUEEN & JACK F. WILLIAMS, *TAX ASPECTS OF BANKRUPTCY LAW AND PRACTICE* ¶ 12.23 (3d ed. 2012).

⁶⁴ MCQUEEN & WILLIAMS, *supra* note 63, ¶ 12.23 (noting that a secured tax claim cannot be subordinated to priority claims or unsecured creditors).

⁶⁵ 11 U.S.C. §§ 1122, 1123(a)(4).

⁶⁶ *Id.* § 1123(a)(2). A claim is generally impaired if the plan does not leave unaltered the claim holder's prebankruptcy, legal, equitable, and contractual rights. *Id.* § 1124(1). See generally *id.* § 1122 (classification of claims).

⁶⁷ INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 5.17.10.9.2 (2010).

⁶⁸ 11 U.S.C. § 1126(c); see also *id.* § 1126(f), (g) (noting, generally, that unimpaired classes are presumed to accept the plan, and that classes receiving no payment are presumed to reject the plan).

⁶⁹ *Id.* § 1129(b). In order to be crammed down, the plan must not "discriminate unfairly" and must be "fair and equitable" with respect to the non-accepting impaired class, as required by the statute. *Id.* § 1129(b)(2)(A).

⁷⁰ See *supra* notes 53–69 and accompanying text. The merits of secured credit have been the subject of a robust scholarly debate. See generally Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996) [hereinafter Bebchuk & Fried, *Uneasy Case*] (arguing that full priority for secured claims produces efficiency costs in bankruptcy and advocating for "partial priority"); Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy: Further Thoughts and a Reply to Critics*, 82 CORNELL L. REV. 1279 (1997) [hereinafter Bebchuk & Fried, *Further Thoughts*] (expand-

more, while much of the tax priority literature has concerned the treatment of *unsecured* tax debts as compared with other unsecured debts, the presence of secured debt has important implications for the tax priority debate. For example, because security interests can constitute much of the value of a bankrupt's assets in a Chapter 7 liquidation bankruptcy, there may be little or no value remaining in the estate to allocate to priority creditors, and the eighth priority tax claim frequently may remain unpaid.⁷¹ On the one hand, one might argue that this makes tax priority unnecessary and possibly even harmful to general unsecured and lower priority creditors.⁷² However, this could possibly be an argument for greater, not lesser, priority for tax claims, particularly given that secured tax claims are already subordinated to the § 507(a)(1)–(7) priority claims.⁷³ Moreover, tax priority remains important in determining the amount the government may recover in Chapter 11 and 13 reorganization bankruptcies.⁷⁴

C. Discharge

The dischargeability of a debt goes to the question of whether liability for continued payment of that debt is released at the conclusion of the bankruptcy, or whether such debt survives the bankruptcy.⁷⁵ Thus, the tax priority provisions cannot be fully evaluated without reference to the provisions governing the discharge of debts in bankruptcy.

A discharge is available to an individual debtor (but not to non-individual debtors) in a voluntary Chapter 7 case for debts arising before the petition date, unless certain requirements are met.⁷⁶ Notwithstanding the Chapter 7 discharge

ing upon the “partial priority” argument); Elizabeth Warren, *Making Policy with Imperfect Information: The Article 9 Full Priority Debates*, 82 CORNELL L. REV. 1373 (1997) (surveying the debate).

⁷¹ See *Bankruptcy FAQ*, NAT'L ASS'N BANKR. TRUSTEES, <http://www.nabt.com/faq.cfm>, archived at <http://perma.cc/X7Y6-P6J9> (last visited Feb. 3, 2014) (noting that in about ninety percent of bankruptcy cases, there are no assets available for liquidation because assets are exempt or subject to a security interest); see also Jiménez, *supra* note 43, at 797, 803 (noting the dearth of distribution to any unsecured creditors); Baird et al., *supra* note 46, at 11 (noting the same with regard to small business Chapter 11 cases).

⁷² See, e.g., Michelle Arnopol Cecil, *Crumbs for Oliver Twist: Resolving the Conflict Between Tax and Support Claims in Bankruptcy*, 20 VA. TAX REV. 719, 767–68 (2001) (noting that tax priority, in light of nondischargeability issues and the high proportion of no-asset debtors, actually endangers domestic support creditors that rely on the debtor's post-confirmation assets for their personal welfare).

⁷³ Cf. Jiménez, *supra* note 43, at 804 (describing proposed legislation that was meant to balance tax priority against domestic support obligations and comparing legislation to survey results illustrating the lack of efficacy of such measures).

⁷⁴ See *supra* notes 44–52 and accompanying text (discussing priority taxes in Chapter 11 and 13 bankruptcies).

⁷⁵ See, e.g., 11 U.S.C. § 727 (2012).

⁷⁶ *Id.* § 727. Corporate debtors filing Chapter 7 do not get a discharge. *Id.* § 727(a)(1); Note, *Switching Priorities: Elevating the Status of Tort Claims in Bankruptcy in Pursuit of Optimal Deterrence*, 116 HARV. L. REV. 2541, 2549 (2003) [hereinafter *Switching Priorities*].

for individuals, 11 U.S.C. § 523 lists certain debts that are excepted from discharge, including the § 507(a)(8) priority tax claims.⁷⁷ Also excepted from bankruptcy discharge under § 523 are: (1) taxes with respect to which a required tax return (or its equivalent) was not filed or was late filed (taking extensions into account) after two years before the bankruptcy petition date and (2) taxes that the debtor willfully attempted to evade or with respect to which the debtor filed a fraudulent return.⁷⁸ In sum, in individual Chapter 7 cases, the eighth priority taxes, together with unfiled or fraudulently evaded taxes, are nondischargeable. This illustrates the longstanding link between priority and dischargeability in individual liquidation bankruptcy cases. Because of the relationship between priority and nondischargeability, it is often difficult to know whether observed debtor and creditor behaviors are a result of priority or of exemption from discharge.

Unlike Chapter 7, confirmation of a Chapter 11 plan of reorganization generally discharges a corporate debtor from any debts arising before the plan confirmation date, unless the corporation made a fraudulent return or willfully attempted to evade or defeat the tax.⁷⁹ In contrast, the 11 U.S.C. § 523 exceptions from discharge—including the exceptions for 11 U.S.C. § 507(a)(8) priority tax claims and certain other tax debts—will apply in the case of an individual debtor in Chapter 11.⁸⁰

The Chapter 13 discharge is broader than the discharge available under either Chapter 7 or Chapter 11 and generally discharges all debts provided for by the Chapter 13 payment plan as well as all disallowed claims, once all payments under the plan have been completed.⁸¹ Certain tax debts are nonetheless excepted from the Chapter 13 discharge; these generally include trust fund taxes,⁸² taxes with respect to which a required tax return was not filed or was late filed within two years of the bankruptcy petition date, and taxes that the debtor willfully attempted to evade or with respect to which the debtor filed a fraudulent return.⁸³ On the other hand, tax penalties and amounts borrowed to pay nondischargeable federal, state, and local taxes are dischargeable under Chapter 13—though such amounts are not dischargeable in a Chapter 7 bankruptcy.⁸⁴

⁷⁷ 11 U.S.C. § 523(a)(1)(A).

⁷⁸ *Id.* § 523(a)(1)(B)–(C).

⁷⁹ *Id.* § 1141(d)(1)(A), (d)(6)(B).

⁸⁰ *Id.* § 1141(d)(2).

⁸¹ *Id.* § 1328(a).

⁸² *Id.* § 507(a)(8)(C) (granting priority to trust fund taxes); *id.* § 1328(a)(2) (denying the discharge of such tax claims following completion of a Chapter 13 plan). Exceptions to Chapter 13 discharge do not include other § 507(a)(8) priority taxes, though such taxes must generally be paid in full under the Chapter 13 plan anyway. *See id.* § 1322(a)(2) (requiring full payment of all claims due priority under § 507 unless the creditor agrees to different treatment).

⁸³ *Id.* § 523(a)(1)(B)–(C); *id.* § 1328(a)(2).

⁸⁴ *Id.* §§ 523(a)(7), (14), 1328(a)(2).

In sum, in individual Chapter 7 and 11 bankruptcy cases, the § 507(a)(8) priority taxes are exempt from bankruptcy discharge along with unfilled taxes and willfully or fraudulently evaded taxes. Trust fund taxes, unfilled taxes, and willfully or fraudulently evaded taxes are also generally exempt from the Chapter 13 discharge. Thus, unfilled taxes and taxes the debtor willfully or fraudulently evaded are never dischargeable. This illustrates a longstanding link between the priority of certain tax debts and their exemption from bankruptcy discharge under U.S. bankruptcy law, at least with respect to individuals.⁸⁵ This link has been justified on the grounds that once a debt has been made nondischargeable, priority is necessary to preserve the fresh start for individual bankrupts.⁸⁶ Although it is possible to sever the link between priority and discharge in consumer bankruptcies, this is unlikely to occur because of the impact of such severance on the debtor's fresh start.⁸⁷ Thus, this Article approaches the tax priority question by assuming a continuing link between priority and nondischargeability in consumer bankruptcies.

On the business side, the confirmation of a Chapter 11 plan of reorganization results in the discharge of most pre-confirmation tax debts.⁸⁸ Thus, except in the narrow circumstances involving fraud or willful evasion, the elimination of tax priority could hurt the government because tax debts not provided for in the Chapter 11 plan may become uncollectible after the bankruptcy.⁸⁹ Thus, the interaction of priority and dischargeability are slightly different in the business bankruptcy context and give rise to different dynamics.

Finally, it should be noted that where a Notice of Federal Tax Lien ("NFTL") has been properly filed, the federal tax lien may survive a Chapter 7

⁸⁵ See *supra* notes 75–84 and accompanying text.

⁸⁶ See *Day*, *supra* note 14, at 566; *Morgan*, *supra* note 14, at 465; *Williams*, *NBRC Tax Recommendations*, *supra* note 14, at 52 ("To the extent a tax claim is both a priority and a non-dischargeable claim, its priority status ensures some dividend that then redounds to the benefit of a debtor faced with an appealing reduction in the non-dischargeable claim.").

⁸⁷ S. REP. NO. 95-989, at 14 (1978) (noting that the new bankruptcy code "continues the basic coordination of [tax] priority and discharge provisions" in order "to avoid unduly burdening the debtor's fresh start"); H.R. REP. NO. 95-595, at 190 (1977) ("By granting the nondischargeable tax a priority, more of it will be paid in the bankruptcy case, leaving less of a debt for the debtor after the case."); *Day*, *supra* note 14, at 566; *Morgan*, *supra* note 14, at 465; *Williams*, *Rethinking Bankruptcy and Tax Policy*, *supra* note 14, at 196 (discussing policy issues concerning the design of tax priority); *Williams*, *NBRC Tax Recommendations*, *supra* note 14, at 52. *But see* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H.R. DOC. NO. 93-137, pt. 1, at 215 (1973) (recommending "that the priority accorded a tax claim be determined apart from its dischargeability"). Retaining priority while removing dischargeability, which is another possible approach, might make bankruptcy too attractive an option for those trying to avoid paying taxes. See *infra* note 108 and accompanying text (discussing the potential free rider problem).

⁸⁸ 11 U.S.C. § 1141(d)(1)(A), (d)(6)(B).

⁸⁹ *Cf. id.* As discussed, the corporate debtor does not get a subsequent discharge if it later liquidates in a Chapter 7 proceeding. *Switching Priorities*, *supra* note 76, at 2549.

bankruptcy, even if the underlying debt is discharged.⁹⁰ This may occur, for example, if the debtor emerges from bankruptcy holding property exempt from distribution, but upon which a NFTL has been filed. In such case, the tax lien continues to be enforceable against the lien property even after the bankruptcy is concluded and even if the underlying tax claim was discharged.⁹¹

II. THE PRIORITY WARS: ARGUMENTS FOR AND AGAINST TAX PRIORITY

The question of whether tax debts should be accorded bankruptcy priority has been the subject of a lengthy debate. Arguments for and against tax priority have arisen in both the consumer and business bankruptcy contexts, and many of these arguments are applicable to both.⁹² This Part surveys both sides of the debate. Section A describes the arguments that have traditionally been invoked in favor of tax priority.⁹³ Section B generally describes the more recent tide of arguments against tax priority.⁹⁴ Finally, Section C characterizes the anti-tax priority case as being at core an efficiency case premised on the government's superior ability to diversify against debtor default risk.⁹⁵

A. The Case for Tax Priority

The idea that at least some tax debts should have bankruptcy priority has been around for a long time.⁹⁶ In the United States, tax priority was a feature of the Bankruptcy Act of 1898,⁹⁷ the first long-lasting modern bankruptcy legislation to be enacted, though the notion that tax debts should be paid ahead of other creditors was also included in earlier and shorter-lived bankruptcy acts.⁹⁸ The

⁹⁰ See AM. BAR ASSOC., *supra* note 60, ¶ 21.1.4.1.1.

⁹¹ *Id.*

⁹² See, e.g., Day, *supra* note 14, at 566–68 (discussing policy arguments for and against tax priority that are applicable to both business and consumer bankruptcy). This is so even though commentators sometimes do not clarify which type of bankruptcy they are discussing. See *id.*

⁹³ See *infra* notes 96–118 and accompanying text.

⁹⁴ See *infra* notes 119–133 and accompanying text.

⁹⁵ See *infra* notes 134–156 and accompanying text.

⁹⁶ Morgan, *supra* note 14, at 463 (“The government’s favored treatment for its revenue claims is of ancient origin.”).

⁹⁷ See ch. 541, § 64(a), 30 Stat. 544, 563 (repealed 1978) (providing that the trustee must pay all taxes “legally due and owing by the bankrupt to the United States, State, county, district, or municipality in advance of the payment of dividends to creditors”). This priority was paired with a provision making tax debts nondischargeable in the bankruptcy. *Id.* § 17. For a survey of the early evolution of government priority, see Plumb, *Federal Priority in Insolvency*, *supra* note 13, at 3–10.

⁹⁸ The Bankruptcy Act of 1800, the United States’ first official federal bankruptcy law, did not provide for priorities—including priorities for secured creditors. See ch. 19, 2 Stat. 19 (repealed 1803). Governmental priority was, however, a feature of the Bankruptcy Act of 1841. See ch. 9, § 5, 5 Stat. 440, 445 (repealed 1843) (providing that debts owed to the United States must be paid first out of debtor assets). The subsequently enacted Bankruptcy Act of 1867 adopted a mixed approach, providing for tax priority in the final bankruptcy distribution to creditors but not the first. See ch. 176, §§ 27–28, 14 Stat. 517, 529–30 (repealed 1878).

Bankruptcy Reform Act of 1978, which replaced the 1898 Act, retained priorities for certain tax debts but narrowed the categories of tax debts eligible for priority and also moved tax claims down to the sixth priority position.⁹⁹ A circumscribed set of taxes retains priority in the eighth position today.¹⁰⁰ One could argue that the falling priority of tax debts in relation to other debts into its present eighth position constitutes a de facto partial repeal of tax priority.¹⁰¹ As Part II, Section C will discuss, this may reflect a judgment that the government is better able to bear debtor default risk than some other types of creditors, who require higher priority treatment.¹⁰²

The priority accorded to tax debts has been justified on a number of grounds.¹⁰³ One longstanding argument in favor of tax priority is that priority is justified for reasons of fairness as between taxpayers and is necessary to preserve the integrity and functioning of the tax system.¹⁰⁴ The fact that the tax system generally works on a voluntary assessment model and is dependent on taxpayer cooperation has been recognized by scholars as well as the IRS.¹⁰⁵ The functioning of the tax system depends, in part, on taxpayer perceptions of fairness; thus, shifting the burden of raising revenue to compliant taxpayers might threaten this system by being perceived as unfair.¹⁰⁶

⁹⁹ See Pub. L. 95-598, § 507(a)(6), 92 Stat. 2549, 2584–85 (codified as amended at 11 U.S.C. § 507 (2012)). This Act provided for tax claims to be paid after administrative expenses, certain wage claims and claims for employee benefit plan contributions, and certain deposits by individuals. *Id.* § 507(a). Prior to the 1978 Act, the bankruptcy law provided fourth priority position for “taxes legally due and owing by the bankrupt to the United States or any State or any Subdivision thereof,” after administrative expenses, certain wage claims, and certain other costs of creditors. See Bankruptcy Act of 1898, § 64(a)(1)–(4). Tax priorities under the 1978 Act were somewhat more generous than those recommended by the 1970 Commission on the Bankruptcy Laws of the United States in their 1973 Bankruptcy Commission Report. Compare § 507(a)(6), 92 Stat. at 2584–85 (granting priority in effect to all tax claims), with REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, *supra* note 87, at 216 (recommending limiting tax priority to certain income and ad valorem taxes).

¹⁰⁰ See 11 U.S.C. § 507(a)(8).

¹⁰¹ See *supra* notes 96–100 and accompanying text (documenting the reduction, over several centuries, of priority for government claims).

¹⁰² See *infra* notes 134–156 and accompanying text.

¹⁰³ See Day, *supra* note 14, at 566–68 (discussing policy justifications for tax priority); Morgan, *supra* note 14, at 463–65 (same); Williams, *Rethinking Bankruptcy and Tax Policy*, *supra* note 14, at 196–97 (discussing policy issues concerning the design of tax priority); Williams, *NBRC Tax Recommendations*, *supra* note 14, at 47–52.

¹⁰⁴ See Jack F. Williams & Tamara Miles Ogier, *A Collision of Policy, Chapter 13 and Taxes*, 50 S.C. L. REV. 313, 325 (1999) (noting that “the American tax system is one of voluntary compliance and assessment” and that “[t]o foster voluntary compliance, the federal government must impose taxes that are perceived as fair and equitable”).

¹⁰⁵ *Id.* at 325–26 (describing how IRS policy developed to foster voluntary compliance in the wake of legislative inquiry).

¹⁰⁶ See *id.* The point has also been noted in the legislative history to the 1978 Bankruptcy Reform Act. See S. REP. NO. 95-989, at 14 (1978) (noting that “tax systems . . . work[] to the extent that the majority of taxpayers think they are fair” and that “[t]his presumption of fairness . . . should be protected and not jeopardized by permitting taxpayers to use bankruptcy as a means of improperly avoid-

Along the same lines, some commentators have argued that because tax revenues are for the benefit of the general public, they must be protected through priority.¹⁰⁷ This justification contains an implicit economic analysis: To the extent that tax revenues are used to finance public goods, government provision is susceptible to the free rider problem, and bankruptcy might be too effective a way to free ride if tax debts are not protected with preferential status.¹⁰⁸

Another group of arguments in favor of tax priority points to the special characteristics of the tax creditor. For example, proponents of tax priority argue that the government is an involuntary creditor limited in its ability to select debtors to whom to lend.¹⁰⁹ Furthermore, the tax creditor cannot take a security interest in the taxpayer's property before the taxes are actually due.¹¹⁰ It is also argued that it takes the tax creditor more time than other creditors to track down delinquent taxpayers.¹¹¹ All of these arguments regarding tax creditor characteristics were made in the House Committee Report to the 1978 Bankruptcy Reform Act.¹¹²

Supporters of tax priority also point to its importance in light of taxpayer behavior, noting that business taxpayers are likely to stop paying taxes before ceasing payments to other creditors, in part because it is harder for the tax credi-

ing their tax debts"). The Senate Committee noted, however, that to balance the interests of the debtor, the general creditors, and the tax creditor, tax priority should be narrowed to more recent taxes so that "stale" taxes will not unduly burden general creditors who have lent to the debtor after the tax liabilities arose. *Id.*

¹⁰⁷ Day, *supra* note 14, at 566 ("The priority [of tax claims] protects the revenue base for the public good and avoids shifting the burden of the debtor's unpaid taxes to other taxpayers."); Frances R. Hill, *Toward a Theory of Bankruptcy Tax: A Statutory Coordination Approach*, 50 TAX LAW. 103, 149 (1996) ("[c]ollecting revenue for government operations is an indicium of sovereignty and has no private counterpart"); Morgan, *supra* note 14, at 463 (same); see also Williams & Ogier, *supra* note 104, at 325 (noting that "an incentive exists to avoid paying a tax, shifting the burden to others" because government "outlays are beneficial to all people whether or not they have paid a tax").

¹⁰⁸ See Williams & Ogier, *supra* note 104, at 325–26. Note that the public goods argument is related to, but different from, the social insurance argument presented in Part III of this Article. See *infra* notes 168–182 and accompanying text. Note also that this analysis assumes that nonpriority taxes will also be dischargeable in the bankruptcy.

¹⁰⁹ See Day, *supra* note 14, at 566 (explaining how tax collectors are "unable to choose their debtor"); Hill, *supra* note 107, at 149 (describing how the IRS is "a nonconsensual creditor because it had no discretion in choosing those from whom it must collect taxes"); López-Ibor & Artés-Caselles, *supra* note 14, at 6 ("The Public Treasury cannot use a list of defaulting debtors or consult its own data base to reject debtors who do not have a risk-free economic and financial profile, or to charge them higher rates."); see also H.R. REP. NO. 95-595, at 190 (1977) (making a similar observation).

¹¹⁰ H.R. REP. NO. 95-595, at 190; Day, *supra* note 14, at 566; Hill, *supra* note 107, at 150 ("The Service may not take any action before a taxpayer has refused to pay, and then may act only subject to significant limitations.").

¹¹¹ H.R. REP. NO. 95-595, at 190.

¹¹² *Id.* Like the Senate Committee, however, the House Committee recognized the need for time limits on tax priority so as not to give the government priority for "taxes that are unassessed or uncollected through a lack of due diligence." *Id.* at 191; see S. REP. NO. 95-989, at 215–16 (1978). In setting such time limits, time extensions for payment are taken into account so as not to disincentivize the tax creditor from granting extensions to distressed taxpayers. H.R. REP. NO. 95-595, at 190.

tor to notice that such nonpayment is occurring.¹¹³ Thus, priority is needed to prevent taxpayers from using unpaid taxes as an additional line of credit when cash is short.¹¹⁴

Additionally, some commentators have argued that if the government feels protected by priority, it will have an incentive to exercise forbearance in collecting taxes from distressed taxpayers prior to bankruptcy, which may help avoid preventable bankruptcies.¹¹⁵ Such increased forbearance by the government may effectively function as an indirect means of completing or supplementing pre-bankruptcy capital markets, and may help keep marginal bankruptcy filers afloat.¹¹⁶

Finally and somewhat circularly, some argue for tax priority based on the idea that priority is necessary to effectuate an individual debtor's fresh start in a world where some tax debts are nondischargeable.¹¹⁷ In other words, priority for nondischargeable tax debts is necessary to ensure that the amount left undischarged after the bankruptcy is not too great.¹¹⁸

B. Arguments Against Tax Priority

Despite the traditional arguments for tax priority, there have long been arguments on the other side.¹¹⁹ As early as 1942, Harold Wurzel pointed to the unfairness of privileging the tax creditor, noting that priorities represent "a deliberate derogation from the basic idea of bankruptcy, which is to cannibalize and restrain the individualism of creditors, to destroy all undue preferences, [and] to create an atmosphere of equality with a proportionate share to the individual

¹¹³ H.R. REP. NO. 95-595, at 193.

¹¹⁴ Cf. James Andreoni, *IRS as Loan Shark: Tax Compliance with Borrowing Constraints*, 49 J. PUB. ECON. 35, 35 (1992) (arguing that taxpayers facing "binding borrowing constraints may use tax evasion to transfer resources from the future to the present"); Williams & Ogier, *supra* note 104, at 325 (noting that some taxpayers "have the worst of intentions in seeking bankruptcy relief, including using the bankruptcy process in a continuing effort to evade the payment of taxes"); Williams, *NBRC Tax Recommendations*, *supra* note 14, at 52 ("Congress is concerned that bankruptcy not become a tax haven.").

¹¹⁵ See Day, *supra* note 14, at 566 (noting that priority is "beneficial to reorganization" because "if taxing authorities are not reasonably secure, they will be discouraged from negotiating payment terms with debtors, thus forcing premature and possibly unnecessary business failures"); Morgan, *supra* note 14, at 465 (citing REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, *supra* note 87, at 216); see also James Andreoni, *The Desirability of a Permanent Tax Amnesty*, 45 J. PUB. ECON. 143, 144-45 (1991) (suggesting that tax amnesty can function "as a partial social insurance"); Oei, *Social Insurance*, *supra* note 1, at 459 (noting that nondischargeability may, in certain circumstances, encourage collectors to delay collection).

¹¹⁶ See Day, *supra* note 14, at 566.

¹¹⁷ See *id.*; Morgan, *supra* note 14, at 465; *supra* notes 75-91 and accompanying text (discussing the relationship between dischargeability and the fresh start).

¹¹⁸ S. REP. NO. 95-989, at 14 (1978); H.R. REP. NO. 95-595, at 190 (1977).

¹¹⁹ See Hill, *supra* note 107, at 151 (summarizing the progression of statutory and case law as "an effort to erode the priority accorded the sovereign").

creditor in both distribution and sacrifice.”¹²⁰ Writing in 1967, Professor William Plumb noted that “[t]he Government . . . is in a better position to self-insure its risks than are private parties, for some of whom the failure of even a single major debtor may be ruinous.”¹²¹ Over time, other scholars have raised various other criticisms of tax priority.¹²²

In addition, in the last two decades, various international organizations and country-specific study commissions have argued—in the context of business insolvencies—that tax priority is unjustified, largely on efficiency grounds.¹²³ For example, in its *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*, developed to guide insolvency reform in developing countries, the World Bank took the position that although security interests in collateral should be respected, distributions after that should be made *pari passu* among unsecured creditors, and that priorities among such unsecured creditors (including the tax creditor) are distortive and should be avoided.¹²⁴ Similarly, in its Legal Department publication *Orderly and Effective Insolvency Proceedings*, the International Monetary Fund (IMF) observed that even though secured creditors should have priority based on their *ex ante* negotiated rights,¹²⁵ any other priorities are inequitable to unsecured creditors and may “undermine the efficiency and overall effectiveness of the proceeding” by causing complexity and creditor disengagement.¹²⁶ With respect to tax priorities in particular, the IMF opined that while these may encourage the tax collector “to delay the collection of taxes from a troubled company” and hence facilitate the debtor’s rehabilitation, such a failure to collect taxes “compromise[s] the uniform enforcement of the tax laws . . . and, thereby, undermines the disciplinary force that an effective insolvency law is designed to support.”¹²⁷

Study commissions in various countries have also taken positions reflecting decreasing support for tax priority. Commissions in England, Australia, Canada, Germany, and New Zealand have all recommended limitation or abolition of

¹²⁰ Wurzel, *supra* note 13, at 1141.

¹²¹ Plumb, *Agenda for the Next Decade*, *supra* note 13, at 244.

¹²² See Leonard M. Salter, *Priority Accorded the Sovereign in Bankruptcy: The American and British Views*, 63 COMM. L.J. 354, 354–56 (1958) (comparing U.S. and British approaches to tax priority); Williams, *NBRC Tax Recommendations*, *supra* note 14, at 51 (citing Marsh, *supra* note 14, at 729).

¹²³ See *infra* notes 124–133 and accompanying text. Although much of the recent criticism has occurred in the context of business reorganizations, as opposed to consumer bankruptcies, many of the key arguments against priority are applicable to both the business and consumer contexts. See, e.g., Day, *supra* note 14, at 566–68; *infra* notes 204–206 and accompanying text (documenting the blurry distinction between the business and consumer tax contexts).

¹²⁴ WORLD BANK, PRINCIPLES AND GUIDELINES FOR EFFECTIVE INSOLVENCY AND CREDITOR RIGHTS SYSTEMS 9 (2001), available at http://www.worldbank.org/ifa/ipg_eng.pdf, archived at <http://perma.cc/KVR5-WRB8>; see *id.* ¶¶ 146, 148.

¹²⁵ INT’L MONETARY FUND, ORDERLY AND EFFECTIVE INSOLVENCY PROCEDURES 47–50 (2000).

¹²⁶ *Id.*

¹²⁷ *Id.* at 39.

priority for tax debts, largely on the grounds that priority reduces the efficiency of insolvency proceedings.¹²⁸ Thus, the general trend internationally, at least in terms of business bankruptcies, has been towards a reduction in bankruptcy priority for the government.¹²⁹

On the domestic front, the 1973 *Report of the Commission on the Bankruptcy Laws of the United States* generally recommended limiting tax priorities to income and ad valorem taxes payable within a year prior to the petition date, employment taxes on wages paid within a year prior to the petition date, excise taxes on transactions happening within a year prior to the petition date, and wage withholding taxes.¹³⁰ This is a narrower set of tax priorities than those ultimately enacted in the 1978 Bankruptcy Reform Act.¹³¹ The Commission commented that although the Treasury had previously argued against reducing priorities on the grounds that it would experience a “substantial” revenue reduction, this argument was “unfounded.”¹³² In contrast, the Commission claimed, the data showed that the revenue loss resulting from reductions in tax priority would be offset “perhaps to the extent of fifty percent, by a reduction in the amount of bad debt deductions taken by other creditors.”¹³³

C. The Underpinnings of the Anti-Priority Case: Efficiency and Diversification

The strongest arguments against tax priority consist largely of two underlying claims, which are related:

¹²⁸ See 1 AUSTL. LAW REFORM COMM’N, REPORT NO. 45, GENERAL INSOLVENCY INQUIRY ¶¶ 734–741 (recommending abolition of tax priorities), available at http://www.austlii.edu.au/au/other/alrc/publications/reports/45/45_vol1.pdf, archived at <http://perma.cc/FJ5A-62T6>; REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, *supra* note 87, at 216–17 (citing the 1970 Canada Study Committee on Bankruptcy and Insolvency Legislation’s recommendation against tax priority for the central government); ADVISORY COMM. ON BANKR. & INSOLVENCY, PROPOSED BANKRUPTCY ACT AMENDMENTS 79 (1986), available at <http://www.iiiglobal.org/component/jdownloads/finish/374/1718.html>, archived at <http://perma.cc/4JAW-3KHH> (recommending complete abolition of crown priorities); see also Morgan, *supra* note 14, at 468 n.23 (summarizing the findings of these and other reports).

¹²⁹ See López-Ibor & Artés-Caselles, *supra* note 14, at 2 (noting the recent tendency of national bankruptcy regimes toward elimination of preferential treatment of public creditors).

¹³⁰ REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, *supra* note 87, at 216.

¹³¹ Compare Pub. L. 95-598, § 507(a)(6), 92 Stat. 2549, 2584–85 (codified as amended at 11 U.S.C. § 507(a)(8) (2012)) (granting priority in effect to all tax claims), with REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, *supra* note 87, at 216.

¹³² REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, *supra* note 87, at 216.

¹³³ *Id.* To this author’s knowledge, the precise effects of an elimination of tax priority have not been studied in greater detail.

1. Efficiency

First, the case against tax priority is largely based on the projected efficiency benefits of priority's repeal, and the idea that priorities will adversely impact the economic behaviors and interests of private creditors, with corresponding costs to debtors. For example, some have argued that giving the government tax priority crowds out private creditors and makes them less willing to negotiate, ultimately making it more difficult for the debtor to successfully reorganize.¹³⁴ Critics also argue that tax priority leads to lower availability and higher cost of credit due to the unsecured creditors' increased bankruptcy risk.¹³⁵

The efficiency underpinnings of the anti-tax priority case reflect the influence of "creditors' bargain" theory, arguably the dominant theory in the business bankruptcy literature addressing how bankruptcy value should be allocated among creditors.¹³⁶ Creditors' bargain theory regards the ideal bankruptcy system as a collective proceeding designed to enforce the contractual entitlements negotiated among creditors prior to bankruptcy and thus to maximize the bankruptcy distribution as a whole.¹³⁷ Any deviation from these bargained-for entitlements would lead to inefficient and distortionary behaviors by creditors on the eve of bankruptcy that will ultimately reduce the value of the bankruptcy estate.¹³⁸ Creditors' bargain theory thus supports respecting the rights of secured creditors, who generally have negotiated the most robust prebankruptcy entitlements.¹³⁹ The theory counsels against the award of priority, however, to any un-

¹³⁴ See Williams, *Rethinking Bankruptcy and Tax Policy*, *supra* note 14, at 204 (noting the conflict between priority treatment and the central principle of equal distribution to similarly situated creditors); Williams, *NBRC Tax Recommendations*, *supra* note 14, at 51 ("Particularly in chapter 7 and 13 cases, to the extent any estate assets remain after secured creditors are paid, tax claims gobble up the value . . . [t]he favored treatment accorded tax claims also increases general creditor disenchantment with the entire bankruptcy process").

¹³⁵ See Day, *supra* note 14, at 567 (noting that priorities "can impact the cost and availability of credit, which will increase as funds available for distribution to other creditors decrease"); see also Williams, *NBRC Tax Recommendations*, *supra* note 14, at 51 (noting "general creditor disenchantment with the entire bankruptcy process").

¹³⁶ See Morgan, *supra* note 14, at 491 n.193; see also Jackson, *Creditors' Bargain*, *supra* note 8, at 857 (describing the theory).

¹³⁷ Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 155–56 (1989) ("The cornerstone of the creditors' bargain is the normative claim that prebankruptcy entitlements should be impaired in bankruptcy only when necessary to maximize net asset distributions to the creditors as a group and never to accomplish purely distributional goals."); cf. Warren, *Bankruptcy Policy*, *supra* note 6, at 797–98 (characterizing Douglas Baird's approach to the creditors' bargain theory as vouchsafing "a single justification for bankruptcy: enhancing the collective return to the creditors").

¹³⁸ See Jackson, *Creditors' Bargain*, *supra* note 8, at 862–76. For example, there could be forum shopping and a costly, value-destroying race to the courthouse as each creditor tries to beat out the others and protect its more robust prebankruptcy entitlements. See *id.*

¹³⁹ See *id.* at 871; Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1148 (1979) ("Since creditors remain free to select their own debtors and to set the terms on which they will lend, there is no compelling argument based on con-

secured creditors (including unsecured tax debts of the government) on social or distributive grounds.¹⁴⁰ Although the theory has spawned criticism and counter-proposals from both contractarian¹⁴¹ and traditionalist scholars,¹⁴² it remains influential.

2. Diversification

Second, the anti-tax priority case is buttressed by an underlying assumption that efficiency gains from a removal of priority can be achieved without much

siderations of fairness for adopting one legal rule . . . rather than another"); see also Hill, *supra* note 107, at 109 (noting that due to "the emphasis on creditors' state law entitlements," the creditors' bargain theory is "primarily a theory of the rights of consensual secured creditors"). See generally Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy As (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931 (2004) (interpreting bankruptcy law in accordance with the theory that rights-holders should not be deprived of debtor wealth in favor of third-party and community interests); Steven L. Schwarcz, *The Easy Case for the Priority of Secured Claims in Bankruptcy*, 47 DUKE L.J. 425 (1997) (describing the economic value of secured lending).

¹⁴⁰ WORLD BANK, *supra* note 124, at 44 (noting the recent "reaction against preferential status for unsecured debt and even against the concept of unsecured preferential claims as impeding the perceived objective of insolvency law—namely, to maximize returns for creditors as a whole").

¹⁴¹ See, e.g., David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 473–74 (noting the costliness of the current system's approach to dealing with the dual issues of "asset deployment" (i.e., liquidation vs. reorganization) and "claimant entitlement" (i.e., priority of claims), and describing newer scholarship on auctions, predetermined capital structures, equity cancellation, and bankruptcy's elimination as proposed remedies); see also Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 323–33 (1993) (recommending a new class of "chameleon equity," comprising holders of fixed rights to payment without recourse to individual collection); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 140–41 (1986) (suggesting that a going concern sale of the firm may be preferable to firm owners); James W. Bowers, *Whither What Hits the Fan?: Murphy's Law, Bankruptcy Theory, and the Elementary Economics of Loss Distribution*, 26 GA. L. REV. 27, 79–80 (1991) (advocating elimination of bankruptcy and relegating commercial failure to existing non-bankruptcy law); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1087 (1992) (proposing equity cancellation); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 100–21 (1992) (proposing a pre-planned capital structure alternative); Alan Schwartz, *Bankruptcy Workouts and Debt Contracts*, 36 J. L. & ECON. 595, 614–16 (1993) (same).

¹⁴² Donald R. Korobkin, *The Role of Normative Theory in Bankruptcy Debates*, 82 IOWA L. REV. 75, 88–103 (1996) (documenting traditionalist responses to the creditors' bargain theory); see, e.g., Homer Kripke, *Law and Economics: Measuring the Economic Efficiency of Commercial Law in a Vacuum of Fact*, 133 U. PA. L. REV. 929, 983–85 (1985) (critiquing the theory as lacking a basis in fact); Lynn M. LoPucki, *The Unsecured Creditor's Bargain*, 80 VA. L. REV. 1887, 1891 (1994) ("Security tends to misallocate resources by imposing on unsecured creditors a bargain to which many, if not most, of them have given no meaningful consent . . ."); Omer Tene, *Revisiting the Creditors' Bargain: The Entitlement to the Going-Concern Surplus in Corporate Bankruptcy Reorganizations*, 19 BANKR. DEV. J. 287, 292–93 (2003) (contrasting the ex post approach of current U.S. bankruptcy law with the ex ante approach of creditors' bargain theory); Warren, *Bankruptcy Policy*, *supra* note 6, at 812–14 (deriding the theory's basis in "normative values and empirical assumptions"); William C. Whitford, *What Is Right About Chapter 11*, 72 WASH. U. L.Q. 1379, 1380 (1994) (noting that the theory relies on impossibly perfect market functionality).

cost to the government.¹⁴³ Specifically, critics of tax priority claim that the government is uniquely able to protect itself against the increased exposure to debtor default risk that would result from priority's removal, because (1) it can diversify its risk across the entire population of taxpayers by employing the tools of substantive tax policy and (2) it can also diversify and protect itself against bankruptcy risk by adjusting its approach to tax collection and administration.

a. The Government's Superior Ability to Diversify Against Default Risk via Substantive Tax Law

The first claim is that the government is better able to protect itself against risk than private creditors by virtue of the characteristics of substantive tax law. For example, some have argued that because the government is a creditor to the entire population, it is better able to diversify against the risks of default than private creditors.¹⁴⁴ These commentators note that, unlike private creditors, taxes foregone in bankruptcy are only a small proportion of the taxes owed to the government creditor.¹⁴⁵ Some have even suggested that the government can protect itself by raising tax rates to make up the lost revenue.¹⁴⁶ The government's purported ability to diversify is in contrast to the traditional pro-priority argument that government, unlike private creditors, is a "nonadjusting creditor,"¹⁴⁷ unable

¹⁴³ Hill, *supra* note 107, at 148–50 (“[B]ased on the twin foundations of an attack on sovereign priorities and assertions of the Service’s ability to absorb and spread costs, as well as an implicit argument that it is a more appropriate cost-spreader than are private creditors, bankruptcy law significantly alters the non-bankruptcy tax assessment and collection process . . . [thus,] bankruptcy theory has rested on the argument that the Service can absorb the cost of nonpayment of tax liabilities”).

¹⁴⁴ López-Ibor & Artés-Caselles, *supra* note 14, at 7–11 (arguing that this is so with respect to all dimensions of risk, including personal risk, portfolio risk, market risk, and global risk); *see also* Morgan, *supra* note 14, at 466 & n.14 (noting that bankruptcy distributions comprise a small portion of government receipts); Plumb, *Agenda for the Next Decade*, *supra* note 13, at 244 (“The Government, drawing its revenue from the entire population, is in a better position to self-insure its risks than are private parties . . .”).

¹⁴⁵ *See* REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, *supra* note 87, at 216 (noting that loss of revenue from elimination of tax priority is likely to be small); Morgan, *supra* note 14, at 466.

¹⁴⁶ Bebchuk & Fried, *Further Thoughts*, *supra* note 70, at 1298 (noting the argument that “the government should not be considered nonadjusting because it has the power . . . to change the tax laws” as well as the bankruptcy laws); Jackson, *Creditors’ Bargain*, *supra* note 8, at 903 (noting that “the state is itself likely to be a claimant . . . in which case the level of priority it provides is part of the cost calculus it has decided on in setting its rates (whether tax rates or otherwise)”). *But see* Hill, *supra* note 107, at 98 (critiquing the argument that the government can recover from lost priority by raising tax rates as “the extreme conceptual cost of attempting to fit tax policy issues into a contract-based theory of private bargaining”).

¹⁴⁷ Bebchuk & Fried, *Uneasy Case*, *supra* note 70, at 1293–1309 (employing the concept of the “nonadjusting creditor”).

to modify its premiums or lending decisions to account for the possibility of debtor default.¹⁴⁸

This claim about the government's ability to diversify against risk manifests in various forms. For example, the claim arises as an argument based on utility and welfare maximization: because the amounts owed to the government in bankruptcy by any single creditor is usually only a small percentage of the government's revenue compared to the amounts owed to private creditors, private creditors will derive greater marginal utility from bankruptcy collections than the government.¹⁴⁹ Thus, denying priority to the sovereign maximizes welfare.¹⁵⁰ Another form of the argument is the idea that because the other creditors of the defaulting debtor presumably also pay taxes, the losses experienced by the government in bankruptcy will be offset by the taxes it subsequently collects from the private creditors of the defaulting taxpayer.¹⁵¹ In other words, the government is able to hedge across different types of taxpayers.

b. The Government's Ability to Protect Itself via Prebankruptcy Tax Administration

The second claim focuses on the prebankruptcy tax administration powers of the government and the assumed impacts of priority on the government's exercise of those powers prior to bankruptcy. Specifically, critics of tax priority have argued that tax priority is unnecessary because, unlike private creditors, the government already has tremendous powers to collect taxes.¹⁵² Such powers include the ability to charge high rates of underpayment interest, the ability to impose penalties, the ability to raise tax rates, the ability to impose "trust fund" liability on third parties, and the ability to deploy its tax collection and administration powers (such as assessment, liens, and levies).¹⁵³ These powers are not

¹⁴⁸ López-Ibor & Artés-Caselles, *supra* note 14, at 15 (arguing that the diversification advantage "is sufficient to make up for [the government] being unable to adjust its risk premiums when the risk of default on the part of one of its debtors increases").

¹⁴⁹ See, e.g., Plumb, *Agenda for the Next Decade*, *supra* note 13, at 244.

¹⁵⁰ *Id.*; López-Ibor & Artés-Caselles, *supra* note 14, at 12–13, 16; see also 1 AUSTL. LAW REFORM COMM'N, *supra* note 128, ¶ 735 ("[t]he net loss to the Commissioner from the abolition of the priority would be insignificant"); Williams, *NBRC Tax Recommendations*, *supra* note 14, at 51 ("There can be no doubt today that whatever amount the government is able to collect as a result of such a priority over what it would receive without it is insignificant; its sacrifice would go completely unnoticed in the vast federal bureaucracy." (quoting Marsh, *supra* note 14, at 729)).

¹⁵¹ Morgan, *supra* note 14, at 466 & n.15; López-Ibor & Artés-Caselles, *supra* note 14, at 16; see also REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, *supra* note 87, at 216 (noting that the loss of revenue from removing priority will be "offset . . . by a reduction in the amount of bad debt deductions taken by the other creditors").

¹⁵² Day, *supra* note 14, at 566–68; Hill, *supra* note 107, at 154; Morgan, *supra* note 14, at 467 n.17.

¹⁵³ See Day, *supra* note 14, at 566–68; Hill, *supra* note 107, at 154; Morgan, *supra* note 14, at 467 n.17.

available to other involuntary or nonconsensual creditors.¹⁵⁴ Thus, through the use of its superior tax administration powers, the government can act to protect itself against debtor default risk.

Tax priority's critics also argue that getting rid of tax priority will cause the government to exercise these extensive tax collection and administration powers more diligently prior to bankruptcy because it will no longer have a preferred position in bankruptcy upon which it can rely.¹⁵⁵ Conversely, critics contend that granting priority to tax debts will lead the tax collector to delay collection of taxes from distressed debtors and to otherwise fail to exercise diligence in the pre-bankruptcy collection of taxes on the theory that it will be able to collect even if the taxpayer files for bankruptcy.¹⁵⁶

* * *

It is possible, perhaps even likely, that elimination of tax priority (and priorities in general) will maximize the value of the bankruptcy distribution and make bankruptcy more efficient in the sense of minimizing distortive borrowing and lending behaviors.¹⁵⁷ The question, however, is what the price of such efficiency will be. In this, the in-bankruptcy analysis of the efficiency question mirrors the tension between efficiency and other considerations (such as equity, administrability, and revenue needs) in tax policy in general.¹⁵⁸ Although a world without any taxes will, under standard economic assumptions, generate fewer efficiency costs than a world where taxes exist, it is generally recognized that given the revenue needs of government, a no-tax world is unfeasible.¹⁵⁹ The real question is how efficiency, revenue, and distributive justice concerns should be weighed against each other in making tax policy.¹⁶⁰

¹⁵⁴ See, e.g., Day, *supra* note 14, at 567–68; see also MICHAEL I. SALTZMAN & LESLIE BOOK, IRS PRACTICE AND PROCEDURE ¶ 14.01 (2013) (comparing the collection processes and powers of general creditors to those of the government).

¹⁵⁵ Morgan, *supra* note 14, at 467 & n.19 (citing 1 AUSTL. LAW REFORM COMM'N, *supra* note 128, ¶ 735); see INT'L MONETARY FUND, *supra* note 125, at 49.

¹⁵⁶ See, e.g., INT'L MONETARY FUND, *supra* note 125, at 49 (noting that tax priority “has been justified on the grounds that giving the government priority with respect to tax claims can be beneficial to the rehabilitation process in that it gives the tax authorities an incentive to delay the collection of taxes from a troubled company”); Day, *supra* note 14, at 568; see also 1 AUSTL. LAW REFORM COMM'N, *supra* note 128, ¶ 735 (noting that priority ensures that the tax commissioner “is under no pressure to recover [payment] in a normal commercial manner”).

¹⁵⁷ See *supra* notes 134–142 and accompanying text (making this point).

¹⁵⁸ See Oei, *Offer-in-Compromise*, *supra* note 1, at 1074.

¹⁵⁹ See Leo P. Martinez, *The Trouble with Taxes: Fairness, Tax Policy, and the Constitution*, 31 HASTINGS CONST. L.Q. 413, 415 (noting that the idea of taxation “is so basic to government that it has been observed that a penniless state cannot protect adequately the rights of its citizens”); see also *Compania Gen. de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (Holmes, J., dissenting) (“Taxes are what we pay for civilized society . . .”).

¹⁶⁰ See Martinez, *supra* note 159, at 415–19; Oei, *Offer-in-Compromise*, *supra* note 1, at 1074.

In this regard, the anti-priority position is that the government will not be unduly harmed by an elimination of tax priority because of its ability to diversify against debtor default risk and protect itself via substantive tax policymaking and tax administration adjustments.¹⁶¹ This Article suggests that the reality is more complicated. The remainder of this Article questions the assumption that efficiency can be achieved with minimal cost to the government and that the government will be able to effectively diversify against the increased debtor default risk stemming from an elimination of tax priority. Part III first sets forth an analytical framework spelling out why it is important to circumscribe the government's share of bankruptcy risk. Part IV then discusses why the government is more constrained than tax priority's critics imagine in its ability to diversify against debtor default risk using substantive tax policy, and why any such diversification may have problematic distributive outcomes. Finally, Part V discusses why the government may also be constrained in its ability to compensate for priority's removal by adjustments in its tax administration behaviors, particularly given anticipated behavioral responses of debtors and other creditors. Together, Parts III through V constitute a comprehensive normative argument, grounded in the realities of tax policymaking and tax administration, for why we should be careful not to burden the government with increased debtor default risk or place too much reliance on the government's ability to spread such risk to other taxpayers.¹⁶²

III. THE IMPORTANCE OF LIMITING THE GOVERNMENT'S SHARE OF DEBTOR DEFAULT RISK IN BANKRUPTCY

Unlike private creditors, the government plays an important role outside of bankruptcy in providing public goods, smoothing consumption, and absorbing economic shocks.¹⁶³ Thus, the appropriate amount of in-bankruptcy debtor default risk borne by the government needs to be understood in tandem with the risk-bearing and other functions performed by government more generally.¹⁶⁴

This Part situates the tax priority debate in the context of the other risk-bearing functions that the government plays, arguing that the level of debtor default risk borne by the government in bankruptcy needs to be circumscribed given the government's nonbankruptcy risk-bearing role. Sections A and B first

¹⁶¹ See *supra* notes 143–156 and accompanying text (describing this argument).

¹⁶² See generally Hill, *supra* note 107, at 151 (noting that such a theory is needed but lacking).

¹⁶³ See, e.g., Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts*, 35 J. CORP. L. 469, 483–99 (2010); Levitin, *supra* note 9, at 483–89; Jeffrey Manns, *Insuring Against a Derivative Disaster: The Case for Decentralized Risk Management*, 98 IOWA L. REV. 1575, 1602–15 (2013). Although this public provision function of government has been recognized by tax priority's defenders, the full risk-bearing function of the government outside of bankruptcy has perhaps received less appreciation. See Ayotte & Skeel, Jr., *supra*, at 483–99; Levitin, *supra* note 9, at 483–89; Manns, *supra*, at 1602–15.

¹⁶⁴ See Hill, *supra* note 107, at 151.

consider consumer bankruptcy.¹⁶⁵ Consumer bankruptcy is often described as playing a social insurance function; therefore, it is relatively intuitive to understand the battle over tax priority in consumer bankruptcy as a fight over the appropriate scope of the government's role as social insurer, both in and outside of bankruptcy.¹⁶⁶ Section C considers business bankruptcies.¹⁶⁷ It argues that, in addition to its myriad other functions, the government's role in smoothing economic shocks suggests the importance of limiting the government's debtor default risk exposure in the business bankruptcy context as well.

A. Consumer Bankruptcy as Social Insurance

Insurance is a mechanism whereby the risks of some are pooled and transferred to another in exchange for a premium, which is imposed on the party whose risks have been transferred.¹⁶⁸ Bankruptcy scholars have recognized that consumer bankruptcy functions as a system of partial social insurance against financial distress in the sense that a bankruptcy filing causes some of the risk of financial distress to be transferred from debtors to creditors in exchange for higher interest rates on (and/or less credit available to) all borrowers prior to bankruptcy.¹⁶⁹ As a result of bankruptcy protection, the creditors of the bankrupt debtor are forced to take on some risk of nonpayment when a debtor files for

¹⁶⁵ See *infra* notes 168–199 and accompanying text.

¹⁶⁶ See *infra* notes 168–199 and accompanying text (expanding upon and considering this assertion).

¹⁶⁷ See *infra* notes 200–209 and accompanying text.

¹⁶⁸ See Feibelman, *supra* note 1, at 130. See generally ALLAN HERBERT WILLETT, *THE ECONOMIC THEORY OF RISK AND INSURANCE* 72 (1951).

¹⁶⁹ See, e.g., WILL DOBBIE & JAE SONG, CTR. FOR ECON. POL'Y RESEARCH, *DEBT RELIEF AND DEBTOR OUTCOMES: MEASURING THE EFFECTS OF CONSUMER BANKRUPTCY PROTECTION* 26 (2013), available at http://www.cepr.org/sites/default/files/events/papers/5599_DOBBIE_Cover%20-%20Debt%20Relief%20and%20Debtor%20Outcomes.pdf, archived at <http://perma.cc/8RV5-JHPG>; Barry Adler et al., *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. LEGAL STUD. 585, 608 (2000) (noting that one of the goals of consumer bankruptcy is “to insure consumers, to the extent possible, against bad income realizations and to reduce moral hazard in connection with lending agreements”); Braucher, *supra* note 7, at 1072–73 (characterizing consumer credit and bankruptcy as stemming from incomplete public and private insurance coverage for the middle class); Feibelman, *supra* note 1, at 129 (“Bankruptcy scholars generally agree that consumer bankruptcy functions, at least in part, as a form of social insurance.”); Hallinan, *supra* note 7, at 100 (noting how a bankruptcy discharge “provides the debtor with credit insurance coverage in an amount equal to his dischargeable liabilities less his nonexempt assets at bankruptcy”); Hynes, *supra* note 6, at 153 (noting that “the most plausible justification for the bankruptcy discharge is that it provides the consumer with a form of insurance that the consumer failed to purchase due to some form of market failure”); Hynes, *supra* note 7, at 350–59 (comparing debt relief to other forms of social insurance); Posner, *supra* note 7, at 307 (observing that “bankruptcy law is analogous to the welfare system: it is social insurance for the nonpoor”); see also Alan B. Krueger & Bruce D. Meyer, *Labor Supply Effects of Social Insurance*, in *HANDBOOK OF PUBLIC ECONOMICS* 2329 (Alan Auerbach & Martin Feldstein eds., 2002) (defining social insurance as “compulsory, contributory government programs that provide benefits to individuals if certain conditions are met”).

bankruptcy.¹⁷⁰ Secured creditors conceptually take on less debtor default risk than unsecured creditors because secured creditors can look to collateral, and this reduced risk is reflected in generally lower interest rates on secured lending.¹⁷¹

As one of several creditors in a bankruptcy proceeding, the government is required to bear part of the burden of providing social insurance through the consumer bankruptcy system. Thus, the question at the crux of the tax priority debate is how much debtor default risk the government should be required to absorb compared to both general unsecured creditors and other priority creditors (as well as secured creditors).¹⁷² Where tax debts have priority and are not dischargeable, the tax creditor is in effect assuming less debtor default risk than general unsecured creditors because the government is in theory more likely to be able to recoup some of the unpaid tax.

Under current law, the priority tax creditor assumes more debtor default risk than private creditors in the first through seventh priority positions.¹⁷³ These higher-priority creditors include certain domestic support obligations, wage claims, and employee benefit contributions.¹⁷⁴ Giving such debts a higher priority than taxes owed the government reflects a legislative judgment that the social insurance or risk-bearing function of those types of private creditors should be limited.¹⁷⁵ This arguably makes sense because if wage, domestic support, and employee contribution claims are defaulted upon, this may put additional pressure on the government to provide a benefit to these creditors through other avenues.¹⁷⁶

Therefore, the question of how much priority tax claims should get in bankruptcy actually reflects a four-way tension between the government, the debtor, general unsecured creditors, and secured and higher-priority unsecured creditors. Those who argue against tax priority are essentially saying that the government should accept the same amount of debtor default risk as general unsecured creditors, and more debtor default risk than priority creditors (assuming they think any priorities should be retained at all). Correspondingly, tax priority's critics either claim that the government will be as able as or more able than private

¹⁷⁰ Richard M. Hynes, *Optimal Bankruptcy in a Non-Optimal World*, 44 B.C. L. REV. 1, 17 (2002).

¹⁷¹ Schwarcz, *supra* note 139, at 429.

¹⁷² See Hill, *supra* note 107, at 150–51; Schwarcz, *supra* note 139, at 429.

¹⁷³ See 11 U.S.C. § 507(a) (2012).

¹⁷⁴ See *id.* § 507(a)(1) (domestic support); *id.* § 507(a)(4) (wage and other claims); *id.* § 507(a)(5) (employee benefit plan contributions). In Chapter 7 bankruptcies, the federal tax lien is also subordinated to the § 507(a)(1)–(7) claims. *Id.* § 724(b).

¹⁷⁵ See, e.g., Cecil, *supra* note 72, at 767–75 (describing the legislative debate over the relative priority levels of domestic support and tax obligations).

¹⁷⁶ See *id.* at 769.

creditors to take steps to diversify against the increased risk or discount the importance of such risk diversification.

It is important to note that, in the case of both the government and private creditors, the incidence of the risk burden may not simply fall on the government and private creditors.¹⁷⁷ Rather, risk may be shifted onto other, compliant taxpayers (in the case of the government) and to other debtors (in the case of private creditors).¹⁷⁸ The fact that denial of tax priority may lead to the imposition of a burden on other taxpayers and a benefit to secured and higher-priority creditors has been recognized in the literature.¹⁷⁹ However, it is possible that the benefits are actually shifted to the other debtors of the secured and higher-priority creditors in the form of lower lending costs or greater credit availability, rather than being captured by the creditors themselves.¹⁸⁰ Conversely, the grant of tax priority may equally result in the shifting of risks and costs to the debtors of nonpriority creditors, rather than the creditors themselves.¹⁸¹ Furthermore, it may be that it is not current taxpayers who will bear the cost of tax priority's elimination (either through higher taxes or lower levels of public provision) but rather future generations of taxpayers.¹⁸²

Parts IV and V of this Article probe the extent to which such risk shifting to other taxpayers may occur and why, despite its potential existence, there are good reasons to retain tax priority. These Parts conclude that the government's ability to shift risk to other taxpayers is subject to a number of significant constraints and may also lead to problematic distributive consequences.

B. Tax Priority as a Structural Limitation on the Government's Overall Social Insurance Burden

Consumer bankruptcy is not the only channel through which social insurance is delivered.¹⁸³ The government administers several direct social insurance and assurance programs, such as social security (including Medicare), unemployment insurance, and workers' compensation.¹⁸⁴ Some of these programs

¹⁷⁷ See *infra* notes 178–182 and accompanying text.

¹⁷⁸ See Oei, *Social Insurance*, *supra* note 1, at 452.

¹⁷⁹ See Hill, *supra* note 107, at 148. For example, Frances Hill has argued that the denial of tax priority leads to a "value shift" from taxpayers to secured creditors or creditors that hold claims with higher priorities. *Id.*

¹⁸⁰ See Schwarcz, *supra* note 139, at 429.

¹⁸¹ See *id.*

¹⁸² See PUBLIC INSURANCE AND PRIVATE MARKETS 10 (Jeffrey R. Brown ed., 2010) (describing the effect of some tax policy decisions as intergenerational cost-shifting).

¹⁸³ See Feibelman, *supra* note 1, at 138–39.

¹⁸⁴ See, e.g., 5 U.S.C. §§ 8101–8193 (2012) (providing workers' compensation for federal, non-military employees). Workers' compensation for nongovernment employees is regulated by state law. See, e.g., MASS. GEN. LAWS ch. 152, §§ 1–86 (2012) (establishing guidelines for provision of workers' compensation insurance).

may serve as substitutes to consumer bankruptcy.¹⁸⁵ In addition, the government delivers social insurance via indirect methods. These include tax expenditures triggered by financial misfortune or hardship, e.g., the Earned Income Tax Credit (“EITC”) and certain disaster relief through the tax code,¹⁸⁶ and procedures by which the government forbears from tax collection, either by granting the taxpayer more time to pay or by actually forgiving some part of the tax owed.¹⁸⁷ The question of how these disparate systems of social insurance should interact has been the subject of an extensive theoretical literature: scholars disagree on whether delivery should be via direct or indirect methods,¹⁸⁸ whether tax-and-transfer mechanisms are more efficient than legal rules,¹⁸⁹ and whether duplication and overlap in social insurance systems is desirable.¹⁹⁰

¹⁸⁵ See Feibelman, *supra* note 1, at 132; Jonathan D. Fisher, *The Effect of Unemployment Benefits, Welfare Benefits, and Other Income on Personal Bankruptcy*, 23 CONTEMP. ECON. POL’Y 483, 491 (2005) (finding that increases in unemployment benefits decrease the probability of bankruptcy); see also Lars Lefgren & Frank McIntyre, *Explaining the Puzzle of Cross-State Differences in Bankruptcy Rates*, 52 J. L. & ECON. 367, 391 (2009) (finding that certain programs and demographics correlate with cross-state differences in bankruptcy rates, but that the overall size of the public safety net does not).

¹⁸⁶ 26 U.S.C. § 32 (2012) (EITC); *id.* §§ 123, 139, 165, 1033 (providing for myriad, permanent forms of tax relief); Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21 (codified as amended in scattered sections of 26 U.S.C.) (providing for tax relief on a temporary basis); Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, 119 Stat. 2016 (codified as amended in scattered sections of 26 U.S.C.) (same); Gulf Opportunity Zone (GO Zone) Act of 2005, Pub. L. No. 109-135, 119 Stat. 2577 (codified as amended in scattered sections of 26 U.S.C. and at 19 U.S.C. § 4033 (2012)) (same); Heartland Disaster Tax Relief Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (codified as amended in scattered sections of 12 and 26 U.S.C.) (same).

¹⁸⁷ See generally Oei, *Offer-in-Compromise*, *supra* note 1 (describing negotiated forgiveness of tax debts); Oei, *Social Insurance*, *supra* note 1 (explaining the social insurance function of tax leniency).

¹⁸⁸ See Anne Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533, 564–89 (1995) (discussing the limitations of tax-based transfer programs such as the EITC); Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance*, 56 TAX L. REV. 157, 161 (2003); David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 958 (2004).

¹⁸⁹ See Louis Kaplow & Steve Shavell, *Should Legal Rules Favor the Poor? Clarifying the Role of Legal Rules and the Income Tax in Redistributing Income*, 29 J. LEGAL STUD. 821, 834–35 (2000) (favoring the use of tax rules, rather than legal rules, to redistribute income); Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient Than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667, 668 (1994) (developing a “double-distortion” argument that tax rules are more efficient at redistribution than legal rules); see also Ronen Avraham et al., *Revisiting the Roles of Legal Rules and Tax Rules in Income Redistribution: A Response to Kaplow and Shavell*, 89 IOWA L. REV. 1125, 1128–29 (2004) (questioning the assumptions underlying the double-distortion argument of Kaplow and Shavell); Marjorie E. Kornhauser, *Cognitive Theory and the Delivery of Welfare Benefits*, 40 LOY. U. CHI. L.J. 253, 253 (2009) (interrogating the perceived superiority of using the tax system to deliver welfare benefits to the poor from the viewpoint of cognitive theory); Chris William Sanchirico, *Taxes Versus Legal Rules as Instruments for Equity: A More Equitable View*, 29 J. LEGAL STUD. 797, 797–800 (2000) (comparing taxes and legal rules as instruments for equity).

¹⁹⁰ See, e.g., Alstott, *supra* note 188, at 534–35 (challenging the case for integration); Jason Marisam, *Duplicative Delegations*, 63 ADMIN. L. REV. 181, 186 (2011) (arguing that allowing some duplication in administrative delegation may be efficient); Daniel Shavero, *The Minimum Wage, the*

Because the government already performs a robust social insurance role outside of bankruptcy, any increased bankruptcy risk to the government must be weighed against the likely impacts on its capacity to administer social insurance to other socioeconomic groups of recipients through other mechanisms.¹⁹¹ Although it is recognized that the government can complete capital markets and effectively act as a lender of last resort by not pursuing 100% enforcement of all delinquent tax debts,¹⁹² government-provided social insurance that is administered via the indirect mechanism of failing to collect taxes ought not be too extensive, because failure to collect taxes may ultimately compromise the revenues needed to sustain other direct and indirect delivery programs to other segments of the population. Tax priority therefore serves the important function of limiting the social insurance burden undertaken by the government through the non-collection of tax debts, both in bankruptcy and by virtue of its behavioral impacts on debtors and creditors leading up to bankruptcy. Such limitations are important because the government's ability to diversify against risk is subject to important limitations.¹⁹³

The government's social insurance burden in bankruptcy should also be limited for distributive reasons. Although many of the social insurance programs described above insure the risks of poor and working class recipients, bankruptcy-provided social insurance has traditionally benefitted the middle class.¹⁹⁴ Thus, the tax priority question can be reframed as a question of whether the gov-

Earned Income Tax Credit, and Optimal Subsidy Policy, 64 U. CHI. L. REV. 405, 466 (1997) (stating that in order to avoid perverse incentives, focus should be on adopting optimal rate structure rather than on discrete programs); Nancy Staudt, *Redundant Tax and Spending Programs*, 100 NW. U. L. REV. 1197, 1211 (2006) (noting the "strong consensus in the scholarly literature [that] [i]t is time for Congress to replace the multitude of specialized social welfare programs with a single integrated plan"); David A. Weisbach, *Tax Expenditures, Principal-Agent Problems, and Redundancy*, 84 WASH. U. L. REV. 1823, 1839 (2006) (noting that spreading similar functions across different agencies reduces failure risk).

¹⁹¹ This observation underlies the traditional argument for tax priority that tax revenues benefit the general public. That argument, however, has not normally been cast in social insurance terms, nor in terms of relative risk burdens in and outside of bankruptcy. See, e.g., Hill, *supra* note 107, at 106–07 (describing a "value shift from taxpayers to secured and priority creditors" that occurs as a result of bankruptcy tax policies that prevent the government from collecting tax).

¹⁹² See Andreoni, *supra* note 114, at 36, 44 (noting that by enforcing less than full compliance, the government essentially makes loans to borrowing-constrained taxpayers and plays a "positive role . . . in partially completing capital markets"); Andreoni, *supra* note 115, at 157–58 (noting tax amnesty's role in "partially completing the market for social insurance"); Oei, *Social Insurance*, *supra* note 1, at 468 (noting that the IRS, through non-collection policies, acts as lender of last resort).

¹⁹³ See *infra* notes 210–341 and accompanying text.

¹⁹⁴ See Feibelman, *supra* note 1, at 130 & n.3; Melissa Jacoby et al., *Rethinking the Debates over Health Care Financing: Evidence from the Bankruptcy Courts*, 76 N.Y.U. L. REV. 375, 376 (2001) ("Bankruptcy is the ultimate declaration of financial collapse for middle-class Americans."); Elizabeth Warren, *Financial Collapse and Class Status: Who Goes Bankrupt?*, 41 OSGOOD HALL L.J. 115, 116 (2003) (observing that—as measured by occupation, education, and home ownership—more than ninety percent of families in bankruptcy are middle class).

ernment should have to join private unsecured creditors in bearing a proportionate share of the burden of insuring against the financial distress of middle-class consumer debtors in bankruptcy, at the possible expense of other constituencies, such as the poor or the elderly. Although the subject needs further study, the distributive consequences of increased bankruptcy risk on the government need to at least be thought through.

Finally, as a social insurance system, bankruptcy is a relatively poor mechanism for targeting appropriate beneficiaries and risk bearers. With respect to risk bearers, bankruptcy is unique among social insurance systems in that the actual insurers are not the government but instead mostly private creditors, who are forced into the role of insurer through legislative enactment of the constitutionally mandated bankruptcy scheme.¹⁹⁵ A decision about tax priority therefore reflects a weighing of the appropriate relative risks of the government in comparison to other potential risk bearers.¹⁹⁶ It is not always possible to know in advance who those risk bearers might be. On the beneficiaries' side, debtors, and not the government, are in the best position to know their own financial condition, and to decide if and when to file for bankruptcy.¹⁹⁷ Thus, in contrast to direct delivery mechanisms, it is relatively difficult to know in advance who the beneficiaries of bankruptcy-provided social insurance are and which creditors' risks the government is subsidizing by forgoing priority.¹⁹⁸ As a result, it is hard for the government to curb the extent of the risk it is bearing and to monitor for abuses.¹⁹⁹ Given this uncertainty, any measures that expand the risk-bearing role of government in consumer bankruptcy must be carefully evaluated and should be instituted with caution.

C. Limiting the Government's Risk Burden in Business Bankruptcies

Although the social insurance analysis described in this Part has largely been applied to consumer bankruptcies, many of the same arguments and concerns apply to business bankruptcies as well. The government has in recent times increasingly played a social-insurance-like role with respect to business failures as

¹⁹⁵ Hynes, *supra* note 170, at 17.

¹⁹⁶ *See id.*

¹⁹⁷ *See Williams & Ogier, supra* note 104, at 326 (describing debtor motivations for filing bankruptcy); *see also* Susan Block-Lieb, *Why Creditors File So Few Involuntary Petitions and Why the Number Is Not Too Small*, 57 BROOK. L. REV. 803, 835–52 (1991) (explaining that although creditors can force a debtor to file bankruptcy, a decision to file is usually made by the debtor).

¹⁹⁸ *See* Andrew T. Hayashi, *The Legal Salience of Taxation*, 81 U. CHI. L. REV. (forthcoming 2014) (manuscript at 7) (on file with author) (noting arbitrariness in individual choices to seek relief through social insurance programs as well as corresponding inefficiency and perceived unfairness in the identities of beneficiaries and cost-bearers).

¹⁹⁹ *See id.* at 38–41.

well as consumer bankruptcies.²⁰⁰ For example, some of the industry bailouts in the 2008 financial crisis constituted a government intervention to provide certain “too big to fail” industry players with what amounted to a fresh start, with the goals of mitigating the effects of systemic risk and smoothing economic shocks for both individuals and businesses.²⁰¹ It is increasingly recognized that the government has an important role to play in the management of systemic risk, and that ex post measures such as bailouts are as important a component of such risk management as bankruptcy procedures.²⁰² Of course, the choice between non-bankruptcy bailouts and bankruptcy as mechanisms of risk management has distributive implications: the former involves direct costs to taxpayers and the public whereas the latter allocates costs among the debtor’s creditors.²⁰³ Thus, business bankruptcies raise many of the same issues of appropriate risk allocation as consumer bankruptcies. Because taxpayers may have to bear the costs of non-bankruptcy bailouts, it seems reasonable that the government’s share of in-bankruptcy risk should be limited.

Another reason that risk allocation and social insurance issues cannot just be confined to the consumer bankruptcy context is that, from a tax perspective, the line between individuals and businesses is not entirely clear.²⁰⁴ This is the case for a number of reasons. First, many of those who file individual tax returns also have business income, whether from doing business as sole proprietorships or from LLC pass-through income. Some businesspersons are employees, and some employees have additional income from business ventures. Second, since the emergence of LLCs as a business form and the ability to elect the classification of one’s business organization came into effect in 1997, the line between businesses and consumers in the tax context has become even more blurry, and this has impacts in the bankruptcy context.²⁰⁵ Partners in a partnership report their distributive share of income, gains, losses, deductions, and credits on their individual tax return; the partnership entity is not itself subject to tax.²⁰⁶ Thus, an individual bankruptcy filer may have a business income component associated

²⁰⁰ See Ayotte & Skeel, *supra* note 163, at 483–99; Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L.J. 951, 956–59 (1992); Levitin, *supra* note 9, at 483–89.

²⁰¹ See Ayotte & Skeel, *supra* note 163, at 483–99; Levitin, *supra* note 9, at 483–89; Manns, *supra* note 163, at 1602–15.

²⁰² See, e.g., Ayotte & Skeel, *supra* note 163, at 483–99; Levitin, *supra* note 9, at 484–85.

²⁰³ See Ayotte & Skeel, *supra* note 163, at 483–85 (describing costs to taxpayers as one of the costs of “government ad hoc rescue”).

²⁰⁴ See Heather Field, *Checking in on “Check-the-Box,”* 42 LOYOLA L.A. L. REV. 451, 457–71 (2009).

²⁰⁵ See Treas. Reg. §§ 301.7701-2 to -3 (as amended in 2013); Field, *supra* note 204, at 457–71 (surveying the emergence of LLCs and the evolution of the elective classification regime for business entities).

²⁰⁶ See 26 U.S.C. §§ 702–704 (2012).

with her individual tax liabilities. In this way, the social insurance rationale for consumer bankruptcy may indirectly impact business transactions as well.

Finally, it is important to limit the government's share of debtor default risk in the context of business bankruptcies because of how tax revenues are raised and spent. In analyzing tax policy decisions on how to raise revenues, it is not possible to completely segregate business from individual taxation and examine each regime in isolation.²⁰⁷ Furthermore, both individual and corporate income tax revenues go into the Treasury General Fund and are appropriated for government spending on various programs,²⁰⁸ and Social Security taxes and Medicare taxes are credited into the Social Security and Medicare trust funds,²⁰⁹ irrespective of the form of organization of the employer (e.g., sole proprietor or corporation). That is, business tax revenues, as well as individual tax revenues, go to the same place to fund government programs. Because revenues from businesses also contribute to the financing of important government functions, the importance of limiting the government's share of debtor default risk is at stake in business bankruptcies as well.

* * *

In sum, in business as well as consumer bankruptcy cases, tax priority is necessary in order to limit the government's debtor default risk exposure in bankruptcy. Limiting the government's bankruptcy risk exposure is important because the government's risk-bearing, social insurance, and public provision functions extend far beyond bankruptcy, and the government requires adequate revenues to carry out these functions.

As Part IV and V explain, the government's ability to diversify against debtor default risk is subject to underappreciated limitations; thus, we should be concerned about the effects of eliminating tax priority on the government's ability to perform social insurance and other functions through nonbankruptcy avenues.

Moreover, as between bankruptcy and nonbankruptcy mechanisms of risk absorption and social insurance provision, nonbankruptcy mechanisms are likely to be more equitable, better targeted, and generally more efficacious. In sum, the risk-bearing role of the government in bankruptcy needs to be contextualized

²⁰⁷ See, e.g., *supra* notes 204–206 and accompanying text (documenting the blurry distinction between the business and consumer tax contexts).

²⁰⁸ *FAQs: Accounting & Budget*, U.S. DEP'T TREASURY, <http://www.treasury.gov/resource-center/faqs/Budget/Pages/us-budget.aspx>, archived at <http://perma.cc/9QR5-56MH> (last updated Aug. 16, 2012, 4:39 PM).

²⁰⁹ *Trust Fund FAQs*, SOC. SECURITY ADMIN., <http://www.ssa.gov/OACT/ProgData/fundFAQ.html#a0=0>, archived at <http://perma.cc/QR8-ZNDB> (last visited Feb. 4, 2014); *How Is Medicare Funded?*, MEDICARE.GOV, <http://www.medicare.gov/about-us/how-medicare-is-funded/medicare-funding.html>, archived at <http://perma.cc/4SSS-KSRW> (last visited Feb. 2, 2014).

and understood within the broader context of the risk-bearing role of government more generally. It is insufficient to simply address the tax priority question as a purely bankruptcy matter.

IV. CONSTRAINTS ON THE GOVERNMENT'S ABILITY TO SPREAD RISK USING SUBSTANTIVE TAX LAW

One of the key arguments in favor of eliminating tax priority is the contention that the government is better able to diversify against the risk of debtor default than private creditors because it is creditor to the entire nation of taxpayers and can adjust tax policy to raise revenues.²¹⁰ In fact, however, this characterization is an oversimplification. The government's ability to diversify against debtor default risk is subject to a number of constraints. Section A identifies constraints related to non-taxation of certain individuals and entities.²¹¹ Section B discusses the limits of diversification using tax rate policy.²¹² Finally, Section C describes certain distributive consequences of diversification that must be taken into account.²¹³

A. The Existence of Individuals and Entities That Don't Owe Tax

In the first place, the government is not, in fact, creditor to the entire nation. With respect to state taxes, the claim is obviously overbroad because state taxing authorities are not creditors to those who do not reside in the particular state. Even in the case of federal taxes, not every single individual or business entity has a positive tax liability. Taxes are generally imposed on the value of a set amount of assets or income streams, known as the tax base; for example, the income tax is imposed upon taxable income; sales taxes are imposed on the amount of goods purchased or sold; and property taxes are imposed upon the assessed value of property.²¹⁴ Thus, whether or not a particular individual or entity pays tax will depend on how the tax base is defined. If the tax base is defined narrowly, then some taxpayers will have zero tax liability.

1. Holes in the Federal Income Tax Base

A look at the federal income tax illustrates the point that the government does not, in fact, collect income taxes from the entire population. Fiscal Year 2012 budget numbers show four major sources from which federal revenues de-

²¹⁰ See *supra* notes 143–151 and accompanying text.

²¹¹ See *infra* notes 214–246 and accompanying text.

²¹² See *infra* notes 247–255 and accompanying text.

²¹³ See *infra* notes 256–276 and accompanying text.

²¹⁴ See, e.g., 26 U.S.C. § 63 (2012) (imposing the federal income tax on “taxable income”); MASS. GEN. LAWS ch. 64H, § 2 (2012) (imposing sales tax on gross receipts of retail goods); MASS. GEN. LAWS ch. 59, § 2 (2012) (subjecting all real and personal property to taxation, unless exempt).

rive: the individual income tax, the corporate income tax, payroll taxes, and excise taxes.²¹⁵ Of these, the bulk of federal revenues (47%) came from the individual income tax, 34% from payroll taxes, 10% from the corporate income tax, and 3% from excise taxes; the remaining 6% derived from miscellaneous receipts—including estate and gift taxes, customs duties, and Federal Reserve earnings/losses.²¹⁶ Thus, it is clear that the major source of federal revenues is the individual income tax, followed by the payroll tax.

With respect to the individual income tax, certain features of the Internal Revenue Code (“IRC”), including progressivity, personal exemptions, deferral, carryovers, and various tax expenditures, such as credits, deductions, and exclusions, lead to a narrowing of the tax base, with the result that many taxpayers do not actually have any tax liability. For example, the Urban Institute and Brookings Institution Tax Policy Center has estimated that for 2013, 43.3% of individual taxable units will pay no individual income tax.²¹⁷ Out of this number, almost half will pay no income tax because their incomes are too low and tax liability is wiped out by the standard deduction and personal exemptions.²¹⁸ The remainder will pay no income tax because tax expenditures (such as the EITC and Child Tax Credit)²¹⁹ will have eliminated their tax liability.²²⁰ Thus, even if all tax expenditures were repealed, almost half of the 43.3% of nontaxable units would continue to pay no income tax.²²¹ Previous year Tax Policy Center estimates have noted that a substantial proportion of those paying no federal income tax due to the existence of tax expenditures are the elderly and working poor.²²²

²¹⁵ Urban Inst. & Brookings Inst., *Tax Topics: Current Law Distribution of Taxes*, TAX POL’Y CENTER, <http://www.taxpolicycenter.org/taxtopics/currentdistribution.cfm>, archived at <http://perma.cc/L2HJ-J2H6> (last visited Feb. 2, 2014).

²¹⁶ *Id.*

²¹⁷ *Id.*; Urban Inst. & Brookings Inst., *The Numbers*, TAX POL’Y CENTER 1 tbl.T13-0230 (Aug. 29, 2013), <http://www.taxpolicycenter.org/numbers/Content/PDF/T13-0230.pdf>, archived at <http://perma.cc/H8NA-QKQS>.

²¹⁸ Robertson Williams, *And Now for the Movie: Fewer Americans Pay No Federal Income Tax*, TAX POL’Y CENTER (Aug. 29, 2013, 11:51 AM), <http://taxvox.taxpolicycenter.org/2013/08/29/and-now-for-the-movie-fewer-americans-pay-no-federal-income-tax/>, archived at <http://perma.cc/34FH-NYYZ>. See generally 26 U.S.C. § 63 (2012) (defining taxable income); *id.* § 151 (allowing deductions for personal exemptions). The standard deduction and personal exemptions are standard features of the federal tax code that apply to all individual taxpayers and exclude a base amount of income from taxation. RACHEL JOHNSON ET AL., URBAN INST. & BROOKINGS INST., WHY SOME TAX UNITS PAY NO INCOME TAX 1 (July 2011), <http://www.taxpolicycenter.org/UploadedPDF/1001547-Why-No-Income-Tax.pdf>, archived at <http://perma.cc/T6PU-GD9S>.

²¹⁹ See Williams, *supra* note 218. See generally 26 U.S.C. § 24 (2012) (Child Tax Credit); *id.* § 32 (EITC). Tax expenditures are, generally, congressionally authorized provisions that provide tax breaks for certain taxpayers or activities. Williams, *supra* note 218.

²²⁰ *Id.*

²²¹ See *id.*

²²² See JOHNSON ET AL., *supra* note 218, at 2. For 2011, the Tax Policy Center estimated that of the 38 million taxable units who paid no income tax due to tax expenditures, 44% paid no income tax because of tax benefits for the elderly and another 30% because of credits for children and the work-

These data underscore the character of the federal income tax as a generally progressive tax instrument, to the point that certain groups of taxpayers pay no tax whatsoever.²²³ This means that the federal government's ability to diversify against bankruptcy risk across the entire population of individual taxpayers is overstated with respect to the federal income tax.²²⁴ Moreover, the exclusion of certain types of taxpayers from the tax base occurs as a result of tax expenditures, some of which already indirectly deliver social insurance.²²⁵ This suggests that the government should balance its social insurance and risk-bearing role in bankruptcy against the social insurance it already performs via tax expenditures outside of bankruptcy.

2. The Porous Corporate Tax Base

The government's ability to spread risk across corporate taxpayers is also subject to limitations; moreover, the distributive consequences of such risk spreading are not well understood. First, as noted, only about 10% of federal revenues come from the corporate tax, and the proportion of federal revenues raised from the corporate income tax has declined over time.²²⁶ A 2012 Congressional Research Service ("CRS") Report attributed the decline to decreasing effective tax rates, an increase in the amount of business done through pass-through entities, and diminishing corporate sector profits.²²⁷ Generally, only those businesses organized as Subchapter C corporations (6% of all businesses in 2008, down from 17% in 1980) are actually subject to the corporate income tax.²²⁸ The

ing poor. *See id.* IRS data do show, however, that some higher income taxpayers have also been successful in reducing or eliminating their federal income tax liability, including about 0.1% of households earning over \$200,000 per year. *See* Justin Bryan, *High-Income Tax Returns for 2009*, STAT. INCOME BULL., Spring 2012, at 6, 6–7, available at <http://www.irs.gov/pub/irs-soi/12insprbulhighincome.pdf>, archived at <http://perma.cc/8UPY-ANSP>. The percentage of taxpayers not paying federal income tax was lower before the 2008 economic downturn; in 2007, 39.9% of tax units paid no individual federal income tax. *See* Urban Inst. & Brookings Inst., *The Numbers*, TAX POL'Y CENTER 1 tbl.T11-0173 (June 14, 2011), <http://www.taxpolicycenter.org/numbers/Content/PDF/T11-0173.pdf>, archived at <http://perma.cc/9D39-YZU9>.

²²³ *See* Annie Lowry, *After Fiscal Deal, Tax Code May Be the Most Progressive Since 1979*, N.Y. TIMES, Jan. 5, 2013, at B1.

²²⁴ *See supra* notes 217–223 and accompanying text. With respect to state taxes, the size of the taxpayer pool is, of course, smaller than for federal taxes.

²²⁵ *See supra* notes 217–223 and accompanying text.

²²⁶ *See* MARK P. KEIGHTLY & MOLLY F. SHERLOCK, CONG. RESEARCH SERV., R42726, THE CORPORATE INCOME TAX SYSTEM: OVERVIEW AND OPTIONS FOR REFORM 11 (2012), available at <http://www.fas.org/sgp/crs/misc/R42726.pdf>, archived at <http://perma.cc/9BTG-K4JW> (noting that whereas in 1952, the corporate tax generated 32.1% of federal tax revenues, in 2010, it accounted for only 8.9% of revenues).

²²⁷ *See id.* at 7.

²²⁸ *Id.* The report explains the declining percentage as resulting from law changes reducing the maximum marginal individual tax rate below the corporate rate (thus causing businesses to organize as pass-throughs), the availability of elective partnership status for LLCs, and increases in the number of shareholders allowed for S corporations. *Id.* Of course, electing unincorporated entities that have

same report noted that corporate tax revenue collections by the United States was only 2.3% of GDP, lower than the 3.0% average of other OECD countries.²²⁹

Second, even among C corporations, not all actually pay the corporate income tax. A 2008 Government Accountability Office (“GAO”) report found that among corporations subject to tax under Subchapter C, 66.7% of U.S.-controlled domestic corporations filing Forms 1120 and 1120-A²³⁰ paid no tax in the tax year 2005, and this percentage varied between 60.9% and 69.3% in the years 1998 to 2005.²³¹ The same report found that among foreign-controlled domestic corporations, 65.2% reported no U.S. tax liability in 2005, with the percentage varying between 65.2% and 71.7% in the years 1998 to 2005.²³² Among large U.S.-controlled domestic corporations²³³ filing Forms 1120 and 1120-A, 25.5% reported no tax liability in 2005, and the percentage reporting no tax liability varied between 23.2% and 38% between the years 1998 and 2005.²³⁴ Among large foreign-controlled domestic corporations, the percentage reporting no tax liability was 28% in 2005, with the number varying between 29.3% and 53.6% in the years 1998 to 2005.²³⁵ The GAO study found that for most of the large foreign- and U.S.-controlled domestic corporations, the “no tax” outcome was a result of current year deductions that offset current year income before net operating losses, whereas for a smaller percentage, tax liability was eliminated by prior years’ losses.²³⁶ In addition, the GAO study found that between 1998 and

“check[ed]-the-box” to be treated as corporations and certain publicly traded partnerships also pay the corporate tax. Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185, 186 (2004). See generally 26 U.S.C. § 7704 (2012) (regarding treatment of publicly traded partnerships); Treas. Reg. §§ 301.7701-2 to -3 (defining and classifying types of business entities).

²²⁹ KEIGHTLY & SHERLOCK, *supra* note 226, at 13. The term “OECD country” refers to those countries that are members of the Organization for Economic Cooperation and Development. Diane M. Ring, *Risk-Shifting Within a Multinational Corporation: The Incoherence of the U.S. Tax Regime*, 38 B.C. L. REV. 667, 690 (1997).

²³⁰ This group does not include S corporations, RICs, REITs, life insurance companies, or casualty insurance companies, some of which are taxed as pass-throughs. See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-08-957, TAX ADMINISTRATION: COMPARISON OF THE REPORTED TAX LIABILITIES OF FOREIGN AND U.S.-CONTROLLED CORPORATIONS, 1998–2005, at 21 (2008), available at <http://www.gao.gov/new.items/d08957.pdf>, archived at <http://perma.cc/5843-5PQP>.

²³¹ *Id.* app. II tbl.1.

²³² *Id.* The study defines “foreign-controlled domestic corporations” as U.S. corporations with 50% or more of their voting stock owned by foreign persons or entities. *Id.* at 20.

²³³ These are defined as corporations with at least \$250 million of assets or \$50 million of gross receipts. *Id.* at 2. The 2008 GAO report noted that although such corporations constituted “less than 1% of all corporations, they make up over 90% of all assets reported on corporate returns.” *Id.*

²³⁴ *Id.* app. II tbl.1.

²³⁵ *Id.*

²³⁶ See *id.* at 3. In 2005, around 10% of large companies reported sufficient prior years’ losses to eliminate tax liability. *Id.* Although removal of tax priority could increase tax collection through a reduction in bad debt deductions taken by corporations, bad debt deductions are only one component of net operating losses, which can be carried over, and which are a major reason for corporate tax liabilities being zeroed out. U.S. DEP’T OF THE TREASURY, INTERNAL REVENUE SERV., PUB. NO. 535,

2005, about 72% of foreign-controlled domestic corporations and 55% of U.S.-controlled corporations reported no tax liability for at least one of the years, and a larger percentage of foreign-controlled domestic corporations than U.S.-controlled corporations reported no tax liability over multiple years.²³⁷

Along similar lines, one study of the tax burdens of large corporations shows that any government action to spread risk across corporate taxpayers first, is unlikely to result in uniformly greater tax liability for all corporate taxpayers, and second, is likely to have distributive consequences across corporate taxpayers along the lines of taxpayer size, tax planning strategies or opportunities, or industry type.²³⁸ For instance, between 2008 and 2010, the average effective tax rate for the large corporations under study was 18.5%, far below the 35% statutory rate.²³⁹ Although 71 of these companies paid an effective tax rate of more than 30% over three years, 67 companies paid an effective three-year rate of less than 10%, and 30 companies paid less than 0% over three years.²⁴⁰ The study found that despite the variation in taxes paid, the average pretax profits for these three groups of companies was quite similar.²⁴¹ The study also found that the effective tax rates paid varied by industry, with, for example, the retail and wholesale trade and healthcare industries paying substantially more than the industrial machinery sector.²⁴²

These data underscore a further important point: The government's ability to diversify against risk through revenue raising is not unilaterally in the hands of the government—it is also dependent on taxpayer planning, opportunities, and actions.²⁴³ Outside of bankruptcy, both business and individual taxpayers attempt to minimize their tax liability through both lawful and unlawful means. Thus, the government's supposed ability to diversify against bankruptcy risk is exercised in a landscape in which taxpayers routinely seek to avoid, evade, or otherwise minimize their tax liability. In claiming that the government is best able to diver-

BUSINESS EXPENSES 38–40 (Mar. 2013), available at <http://www.irs.gov/pub/irs-pdf/p535.pdf>, archived at <http://perma.cc/EN8J-UBDZ>. Whether a reduction in bad debt deductions constitutes a significant enough component of net operating losses to lead to higher tax collections is an empirical question that needs to be investigated.

²³⁷ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 230, at 8.

²³⁸ See ROBERT S. MCINTYRE ET AL., CORPORATE TAXPAYERS & CORPORATE TAX DODGERS 2008–10, at 3 (2011), available at <http://www.ctj.org/corporatetaxdodgers/CorporateTaxDodgersReport.pdf>, archived at <http://perma.cc/J7FK-EE2X>.

²³⁹ *Id.*

²⁴⁰ *Id.*

²⁴¹ *Id.*

²⁴² *Id.* at 7.

²⁴³ Cf. U.S. DEP'T OF THE TREASURY, UPDATE ON REDUCING THE FEDERAL TAX GAP AND IMPROVING VOLUNTARY COMPLIANCE 2 (2009), available at http://www.irs.gov/pub/newsroom/tax_gap_report_final_version.pdf, archived at <http://perma.cc/Y6XV-HF8G> (estimating only 84% voluntary compliance with the federal tax code); Juan Carlos Molero & Francesc Pujol, *Walking Inside the Potential Tax Evader's Mind: Tax Morale Does Matter*, 105 J. BUS. ETHICS 151, 151 (2012) (exploring ethical and psychological motives for tax evasion).

sify against bankruptcy default risk, priority's critics have overlooked or ignored this unique backdrop.

In addition, the ultimate incidence of the corporate income tax needs to be better understood in order to know whether diversification through the corporate tax is actually just falling on the shoulders of individual taxpayers. Whereas traditional analyses suggest that the incidence of the corporate income tax is ultimately on ownership or capital of the corporation,²⁴⁴ recent studies suggest that labor could bear some of the tax incidence.²⁴⁵ If it is in fact true that labor bears some tax incidence, then increasing taxes on corporations to offset the default risk associated with an elimination of tax priority will effectively generate an increased burden on labor, with the attendant distributive consequences. Moreover, even if the incidence of corporate taxation is 100% on ownership capital, increasing corporate income taxes to offset reduced priority could mean an increased burden on capital ownership (in the form of lower corporate profits) that may ultimately reduce the taxes collected from firm owners.²⁴⁶

B. The Limits of Diversification Using Tax Rate Policy

Setting aside the fact that the income tax base is porous to begin with, the government is also constrained in its ability to diversify against bankruptcy risk by adjusting tax rates.

1. Other Goals of a Tax System

There are many goals in play in the design of a tax system apart from bankruptcy diversification considerations. In addition to the traditional concerns with ensuring that the tax system is efficient, equitable, and administrable, the government must worry about whether the tax system is appropriately progressive, is conducive to economic growth, raises sufficient revenue, and encourages certain behaviors.²⁴⁷ This means that diversification against bankruptcy risk is not a

²⁴⁴ See Jane G. Gravelle & Laurence J. Kotlikoff, *The Incidence and Efficiency Costs of Corporate Taxation When Corporate and Noncorporate Firms Produce the Same Good*, 97 J. POL. ECON. 749, 749–51 (1989); Arnold C. Harberger, *The Incidence of the Corporation Income Tax*, 70 J. POL. ECON. 215, 215 (1962) (noting that under reasonable assumptions, capital bears the incidence of the corporate income tax in the long run).

²⁴⁵ See Li Liu & Rosanne Altshuler, *Measuring the Burden of the Corporate Income Tax Under Imperfect Competition*, 66 NAT'L TAX J. 215, 233 (2013); see also KEIGHTLY & SHERLOCK, *supra* note 226, at 16 (questioning the methodology of research cited by Liu & Altshuler, but noting widespread agreement with the premise).

²⁴⁶ See Don Fullerton, *On the Possibility of an Inverse Relationship Between Tax Rates and Government Revenues*, 19 J. PUB. ECON. 3, 5–8 (1982).

²⁴⁷ See Logue & Avraham, *supra* note 188, at 158. See generally *id.* at 158–61 (discussing the literature on economic and redistributive models of tax law).

goal that can be pursued without consideration of other factors, and is in fact likely to be a goal that is subordinate to other interests of tax policy.²⁴⁸

2. Constraints on Raising Rates

In addition to these conflicting goals that limit the government's ability to diversify against bankruptcy risk, the government may also experience political constraints on its ability to raise tax, interest, and penalty rates.²⁴⁹ For one thing, charging extremely high or adjustable interest rates on tax underpayments, or adjusting tax, interest, and penalty rates charged to different taxpayers based on risk profile may be viewed by the public as unacceptable actions for a government to take.²⁵⁰ Furthermore, significant hikes in tax rates, eliminating certain popular tax expenditures (such as the home mortgage deduction), or eliminating the personal exemption are other examples of measures that are likely to be met with public resistance.²⁵¹ The existence of these constraints suggests that it is overly simplistic to think about the government as some sort of "super-private creditor" that happens to have a bigger and better debtor pool across which to diversify.

3. Indeterminate Impacts of Tax Rate Changes

Finally, even if the government were able to diversify by raising taxes, the impact of such tax policy changes on revenue and economic growth would need to be carefully assessed. It is well known that changes in tax rates may affect taxpayer behavior in different directions due to labor and substitution effects.²⁵² If substitution effects outweigh income effects, it is possible that tax rate increases may decrease labor supply in a way that decreases revenues collected.²⁵³ More broadly, under certain circumstances, tax rate increases may yield changes

²⁴⁸ Adam Feibelman, *Federal Bankruptcy Law and State Sovereign Immunity*, 81 TEX. L. REV. 1381, 1408–11 (2003) (discussing the regulatory and other constraints on sovereign states acting as creditors).

²⁴⁹ *Id.* at 1409–11.

²⁵⁰ *Id.* at 1410–11 (describing some of the political and other constraints on states); López-Ibor & Artés-Caselles, *supra* note 14, at 5–6.

²⁵¹ See, e.g., Grover Norquist, *Read My Lips: No New Taxes*, N.Y. TIMES, July 22, 2011, at A21 (describing a political movement dedicated to securing the commitment of politicians to never increase taxes). It is naïve to think that the government could simply diversify by increasing tax rates. See generally William E. Foster, *Partisan Politics and Income Tax Rates*, 2013 MICH. ST. L. REV. 703 (finding that vast political mandate is necessary for significant tax rate changes).

²⁵² See, e.g., *Tax Reform: Historical Trends in Income and Revenue: Hearing Before the S. Comm. On Fin.*, 111th Cong. 6–7 (2010) (statement of Douglas W. Elmendorf, Director, Congressional Budget Office) (describing how taxes may affect economic activity); Anne L. Alstott, *Work vs. Freedom: A Liberal Challenge to Employment Subsidies*, 108 YALE L.J. 967, 1001–02 (1999) (describing how employment subsidies may have positive substitution effects, while a negative income tax has negative substitution effects).

²⁵³ See *id.* at 11.

in taxable income, labor supply, tax evasion behavior, and economic growth, all of which may compromise desired revenue gains.²⁵⁴ It is difficult to predict in the abstract what the revenue and diversification impacts of a tax policy change will be, and the difficulty of making such predictions may impede the government's ability to diversify against risk.²⁵⁵

C. Equitable and Distributive Considerations

Along with concerns about tax rates and the tax base, equitable consequences of risk diversification must also be considered. Most obviously, risk diversification by imposing higher taxes on compliant taxpayers raises issues of equity between taxpayers who comply and pay their taxes and those who are able to avoid paying their taxes as a result of having filed for bankruptcy.²⁵⁶ It is possible that such inequities give rise to behavioral responses on the part of compliant taxpayers, which may further compromise the revenue base.²⁵⁷

In addition to the obvious issue of fairness between compliant and non-compliant taxpayers, government risk diversification through changes in substantive tax policy raises other distributive issues:

1. Elimination of Tax Priority, Withholding Agents, and Regressivity

Because there is heterogeneity in the types of taxes paid by different groups of taxpayers, elimination of tax priority may be regressive. Take, for example, employer-collected payroll, state and local, and excise taxes. Based on 2013 Tax Policy Center estimates, although a large percentage of individual taxpayers did not pay the federal income tax, almost two-thirds of the 43.3% of taxable units projected to pay no federal income tax did pay *payroll* taxes.²⁵⁸ As has been

²⁵⁴ See, e.g., CONG. BUDGET OFFICE, PUB. NO. 2756, THE EFFECT OF TAX CHANGES ON LABOR SUPPLY IN CBO'S MICROSIMULATION TAX MODEL 3 (2007) (analyzing the labor supply effects of extending various tax relief provisions); Steven E. Crane & Farrokh Nourzad, *Tax Rates and Tax Evasion: Evidence from California Amnesty Data*, 43 NAT'L TAX J. 189, 189–91, 197 (1990) (finding, in the California state income tax context, increased evasion activity in response to higher tax rates); Martin Feldstein, *The Effect of Marginal Tax Rates on Taxable Income: A Panel Study of the 1986 Tax Reform Act*, 103 J. POL. ECON. 551, 552–55 (1995) (finding, based on panel data, that taxable income is highly responsive to changes in marginal tax rates); Raymond Fishman & Shang-Jin Wei, *Tax Rates and Tax Evasion: Evidence from "Missing Imports" in China*, 112 J. POL. ECON. 471, 483 (2004) (finding that a 1% tax rate increase is associated with 3% tax evasion increase); Fullerton, *supra* note 246, at 1–6; see also Basil Dalamagas, *A Dynamic Approach to Tax Evasion*, 39 PUB. FIN. REV. 309, 310 (2011) (noting that estimates of the impact of tax rate changes on tax evasion "differ widely across researchers" under static models).

²⁵⁵ See Dalamagas, *supra* note 254, at 310; Fullerton, *supra* note 246, at 1–6.

²⁵⁶ See Crane & Nourzad, *supra* note 254, at 197.

²⁵⁷ See *infra* notes 258–276 and accompanying text.

²⁵⁸ See Urban Inst. & Brookings Inst., *Tax Topics: Who Doesn't Pay Federal Taxes?*, TAX POL'Y CENTER, <http://www.taxpolicycenter.org/taxtopics/federal-taxes-households.cfm>, archived at <http://perma.cc/68G2-D2ET> (last visited Feb. 2, 2014). These data may appear to support the anti-priority

pointed out by the Center on Budget and Policy Priorities, low- and moderate-income taxpayers pay a greater proportion of their income in payroll taxes than taxpayers of higher income.²⁵⁹

Tax Policy Center numbers show that under current law, for taxable units with some payroll tax liability (i.e., working households), 81.8% had a payroll tax liability greater than their income tax liability in 2012, and 85.9% did in 2013.²⁶⁰ The data also show that lower-income taxable units are more likely to have payroll tax liabilities that exceed federal income tax liabilities than higher-income taxable units: Of the lowest cash income quintile of taxpayers in 2012, 99.2% of those with payroll tax liability had a greater payroll tax liability than income tax liability under current law.²⁶¹ By contrast, in 2012, only 45.8% of the taxable units in the top quintile of cash income with payroll tax liability had payroll tax liabilities greater than income tax liabilities.²⁶²

When excise taxes are added to the picture, it is also clear that lower-income taxpayers pay a bigger share of their income in excise taxes than middle- and higher-income taxpayers.²⁶³ Furthermore, lower-income households that do not pay federal income tax also pay state and local taxes, which tend to be regressive, and tend to pay a larger proportion of their incomes in state and local taxes.²⁶⁴

argument that the government is in fact diversified across the entire population. Yet, according to this data, an estimated 14.4% of households in 2013 paid neither income nor payroll taxes. *Id.*

²⁵⁹ CONG. BUDGET OFFICE, AVERAGE FEDERAL TAX RATES IN 2007, at 2 (2010) [hereinafter CBO, 2007 TAX RATES] (showing that in 2007, taxpayers in the lowest household income quintile paid 8.8% of their household income in “social insurance taxes,” whereas the percentages for taxpayers in the top 10%, 5%, and 1% of household income paid 4.5%, 3.3%, and 1.6% respectively); see also CHUCK MARR & CHYE-CHING HUANG, CTR. ON BUDGET & POLICY PRIORITIES, MISCONCEPTIONS AND REALITIES ABOUT WHO PAYS TAX 5–6 (2012), available at <http://www.cbpp.org/files/5-26-11tax.pdf>, archived at <http://perma.cc/5APA-9BNQ>.

²⁶⁰ Urban Inst. & Brookings Inst., *Tax Topics: Distribution of Tax Units That Pay More in Payroll Taxes Than Individual Income Taxes*, TAX POL’Y CENTER tbls. T13-0235, T13-0236, T13-0237 & T13-0238, <http://www.taxpolicycenter.org/taxtopics/Distribution-of-Federal-Income-and-Payroll-Taxes.cfm>, archived at <http://perma.cc/MY77-XBDK> [hereinafter *Distribution of Tax Units*] (last visited Feb. 2, 2014).

²⁶¹ See *id.* For 2013, the number was 99.4%. *Id.*; see also *id.* (showing also that as cash income level rises, the percentage of working tax units with payroll tax liability greater than income tax liability shrinks).

²⁶² See Urban Inst. & Brookings Inst., *The Numbers*, TAX POL’Y CENTER 1 tbl. T13-0236, <http://www.taxpolicycenter.org/numbers/Content/PDF/T13-0236.pdf>, archived at <http://perma.cc/WMQ4-XW6A> (last visited Feb. 5, 2014). For 2013, the number was 53.8%. See *Distribution of Tax Units*, *supra* note 260, tbl. T13-0238.

²⁶³ CBO, 2007 TAX RATES, *supra* note 259, at 6–7 tbls. 1 & 2; see also MARR & HUANG, *supra* note 259, at 6.

²⁶⁴ See CARL DAVIS ET AL., INST. ON TAXATION & ECON. POL’Y, WHO PAYS? A DISTRIBUTIONAL ANALYSIS OF THE TAX SYSTEMS IN ALL 50 STATES 1 (3d ed. 2009), available at <http://www.itepnet.org/whopays3.pdf>, archived at <http://perma.cc/H5NF-MASC> (finding that “nearly every state and local tax system takes a much greater share of income from middle- and low-income families than from the wealthy”); MARR & HUANG, *supra* note 259, at 6.

Payroll taxes are withheld from employee income and paid over to the IRS by employers, and state sales taxes are likewise collected and paid over by the seller.²⁶⁵ These taxes, which are likely to be regressive, are therefore relatively difficult for employees and purchasers, respectively, to avoid, and are likely to have been withheld by the employer or seller regardless of whether the withholding agent actually hands over the collected amount to the IRS.²⁶⁶ Anecdotal evidence suggests that such unpaid trust fund taxes are a recurrent feature of business bankruptcies.²⁶⁷ Thus, removal of priority would not help the ultimate payors of these taxes (employees and purchasers), but only the withholding agents (employers and businesses).²⁶⁸ This creates an obvious inequity between payors of sales and payroll taxes and the trust fund withholding agents charged with collection of such taxes.

Although some have called for elimination of all tax priorities, other than priorities for trust fund taxes,²⁶⁹ this does not completely solve the problem. Because hard-to-avoid payroll and sales taxes tend to constitute a larger proportion of the incomes of lower-income taxpayers, elimination of all other tax priorities is still likely to disproportionately benefit higher-income taxpayers subject to the income tax.²⁷⁰ Such higher-income taxpayers are likely to have a larger share of their income generated from harder-to-withhold sources, such as capital gains income, business income, foreign income, and dividends.²⁷¹ While avoiding the worst-case scenario, where sellers and employers basically use trust fund taxes collected from workers and consumers as an additional line of credit, the elimination of all tax priorities other than trust fund taxes would still disproportionately favor higher-income taxpayers most able to avoid paying the tax due.²⁷²

²⁶⁵ See 26 U.S.C. § 3102 (2012) (regarding payroll taxes); see also, e.g., MASS. GEN. LAWS ch. 64H, § 3 (2012).

²⁶⁶ Indeed, this is the whole point of using withholding agents to collect those taxes.

²⁶⁷ See Joseph DiGiuseppe, *What Every Tax Practitioner Needs to Know About Trust Fund Taxes and Responsible Person Liability in Bankruptcy*, 17 PRAC. TAX LAW. 7, 7 (2002) (“Many financially distressed businesses fail to account for, collect, and turn over required withholding taxes.”) In other words, employers effectively use the withheld taxes as an additional line of credit at the expense of the government, with the result that sometimes the government does not get paid.

²⁶⁸ To be fair, some commentators have suggested that priority should in any event be retained for such trust fund taxes. See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, *supra* note 87, at 216.

²⁶⁹ See *id.* (arguing against tax priorities other than income and ad valorem taxes).

²⁷⁰ See MARR & HUANG, *supra* note 259, at 6.

²⁷¹ See *id.*

²⁷² See *id.* But see Hynes, *supra* note 7, at 321–26 (suggesting broadly that such regressivity may be justified); Michael Greenstone & Adam Looney, *Just How Progressive Is the U.S. Tax Code*, BROOKINGS (Apr. 13, 2012, 2:53 PM), <http://www.brookings.edu/blogs/up-front/posts/2012/04/13-tax-greenstone-looney>, archived at <http://perma.cc/4MN9-S88H> (noting that the U.S. tax system is less progressive than the tax systems of other industrialized countries and “considerably less progressive today than it was just a few decades ago”).

The potentially regressive impacts of priority's removal are particularly problematic because consumer bankruptcy already seems to benefit middle-class filers.²⁷³ From a consumer bankruptcy standpoint, the distributive consequences of increasing the government's share of debtor default risk in bankruptcy, at the possible expense of the government's ability to deliver social insurance to other demographic groups (due to revenue losses from priority's repeal), must be considered carefully.

2. The Distributive Impacts of Intergenerational Risk Spreading

Scholars and policymakers recognize that one of the advantages of having the government perform social insurance or social assurance functions is its superior ability to spread risk across different generations of taxpayers by increasing taxes on (or lowering benefits to) future generations.²⁷⁴ Whether or not the government chooses to diversify by spreading risk across generations of taxpayers would depend on a number of factors, including how much revenue is lost as a result of priority's repeal, what political and other constraints exist that prevent it from increasing taxes on current taxpayers, and to what extent the government can finance itself through borrowing.

This Article does not claim that the government will, in fact, choose to manage increased revenue losses by passing the costs on to future generations of taxpayers. Nor does it suggest that intergenerational risk transfer is necessarily always a bad thing. The point is merely that intergenerational risk transfer may be employed to offset the revenue losses from bankruptcy and the removal of bankruptcy priority, and that, if this were to happen, there will be distributive, equitable, and efficiency consequences across generations that need to be carefully considered. Simply saying that the government has superior powers of diversification does not say very much about whether the methods of diversification employed are desirable.

3. Distributional Consequences, as Between Business and Individual Taxpayers

There are also likely to be distributive considerations, as between business and individual taxpayers. As discussed above, wage workers are unlikely to benefit from a removal of tax priority because their taxes owed have presumably already been withheld.²⁷⁵ This suggests that a change in the tax priority rule may disproportionately benefit taxpayers with business income. More generally, removal of priority in the context of business bankruptcies may lead to greater tax

²⁷³ See Feibelman, *supra* note 1, at 130 & n.3; Jacoby et al., *supra* note 194, at 376.

²⁷⁴ See PUBLIC INSURANCE AND PRIVATE MARKETS, *supra* note 182, at 10.

²⁷⁵ See *supra* notes 265–272 and accompanying text.

burdens on individual taxpayers, if sovereigns were to attempt to increase taxes on labor in order to diversify against revenue losses from business bankrupts.²⁷⁶ These and other distributive impacts need to be carefully considered.

V. CONSTRAINTS ON THE GOVERNMENT'S ABILITY TO SPREAD RISK USING ITS TAX ADMINISTRATION POWERS

The second key component of the anti-priority case is the notion that the government has sufficient and unique tax collection powers to protect itself against bankruptcy default risk, and that removing tax priority will encourage the government to exercise those powers in an expedient and diligent manner.²⁷⁷ Like the argument about the government's ability to diversify using substantive tax law changes, these contentions are essentially arguments about the government's ability to manage default risk using tax administration tools. Yet a closer look reveals that these contentions are also questionable.

A. The Sufficiency of the Government's Tax Enforcement Powers

It is true that the government's power to collect taxes is immense.²⁷⁸ The federal government has, among its many powers, the federal tax lien, the power to levy against the taxpayer's assets, and the power to use various judicial collection proceedings to facilitate tax collection.²⁷⁹ In addition, the government has tremendous access to information about the financial situation of taxpayers by virtue of tax return filings, third-party information reporting, and mechanisms such as withholding and information sharing.²⁸⁰

On the other hand, whether the government's collections power is (1) significant enough to protect the government against taxpayer default absent tax priority, or (2) more immense than the collections powers available to private creditors is open to debate. Like the government, private creditors are also capable of taking and perfecting security interests, levying on property, or going to court to enforce judgments.²⁸¹ In addition, private creditors also have significant access to debtor information by virtue of credit reports and advances in customer data collection.²⁸²

²⁷⁶ See generally Liu & Altshuler, *supra* note 245, at 233.

²⁷⁷ See *supra* notes 152–156 and accompanying text.

²⁷⁸ See *supra* notes 152–154 and accompanying text (describing the government's tax collection powers).

²⁷⁹ 26 U.S.C. §§ 7403–7405 (2012).

²⁸⁰ See, e.g., *id.* §§ 1441–1446 (withholding provisions on nonresident aliens and foreign corporations); *id.* §§ 6041–6050W (information reporting provisions).

²⁸¹ See, e.g., U.C.C. §§ 9-201 to -210 (2013) (regarding the making of security interests); *id.* §§ 9-301 to -342 (regarding perfection and priority).

²⁸² See PAM DIXON, WORLD PRIVACY FORUM, WHAT INFORMATION DO DATA BROKERS HAVE ON CONSUMERS, AND HOW DO THEY USE IT? 7, 9, 14 (2013), <http://www.commerce.senate.gov/public/>

Furthermore, certain features of the taxing process may make it harder for the government than private creditors to collect tax debts in a timely manner. For example, the annual nature of the taxable period creates delays between the earning of taxable income and its collection that private creditors may not have to deal with.²⁸³ In addition, unlike private creditors, procedural tax law does not allow the government to take a security interest in property prior to the time the tax is due.²⁸⁴ Thus, it is unclear, weighing these factors against each other, whether the government is really able to better protect itself using collection powers than are private creditors.

Finally, even if the government does have greater collection powers on book to enforce collection of tax debts, informal constraints may limit the ways in which the government can exercise these powers.²⁸⁵ Private creditors may have more *actual* power to enforce payment of debts than the government.²⁸⁶ In sum, statements about the extensiveness of the government's tax collection powers are not informative about whether priority is justified unless a robust comparison is undertaken.

B. The Indeterminate Impacts of Priority on Prebankruptcy Tax Collection

Another aspect of the "collection powers" argument against tax priority is the notion that priority's removal will encourage the government to collect diligently and efficiently, and that conversely, priority will cause the government not to exercise commercial diligence.²⁸⁷ Although priority's critics are correct to focus on the relationship between tax priority and the tax collector's actions before bankruptcy, this relationship is complex. To simply assume that removing priority will make the government work harder to collect tax debts prior to bankruptcy fails to account for this complexity for multiple reasons. First, bankruptcy risk is hard to predict. Second, there are other factors that are in play in the design of tax policy and tax collection. Third, there are multiple time periods and phases of

?a=Files.Serve&File_id=c290bd4e-66e4-42ad-94c5-fcd4f9987781, archived at <http://perma.cc/6HAQ-YKR9> (noting that data brokers are selling consumer information organized by credit data as well as age and health demographics).

²⁸³ See DEP'T OF THE TREASURY, INTERNAL REVENUE SERV., PUB. NO. 538, ACCOUNTING PERIODS AND METHODS 2 (rev. Dec. 2012), available at <http://www.irs.gov/pub/irs-pdf/p538.pdf>, archived at <http://perma.cc/5B7A-R5K5>.

²⁸⁴ See *supra* note 56 and accompanying text (discussing the federal tax lien).

²⁸⁵ See Feibelman, *supra* note 248, at 1410–11; *supra* notes 249–251 and accompanying text (discussing potential political constraints).

²⁸⁶ See Feibelman, *supra* note 248, at 1410 (describing states as "constrained financial actors"). For example, as a recent IRS scandal illustrates, political and other constraints may make it seem more egregious if the government were found to be aggressively harassing taxpayers in the collection of tax debts than if such enthusiasm were displayed by a private creditor. See Jonathan Weisman, *After Outcry, Chief of IRS Is Forced Out*, N.Y. TIMES, May 16, 2013, at A1.

²⁸⁷ See Day, *supra* note 14, at 568; Morgan, *supra* note 14, at 467 & n.19 (citing 1988 AUSTRALIA COMMISSION REPORT, *supra* note 128, ¶ 735); *supra* notes 155–156 and accompanying text.

tax collection that must be taken into account, including the phase in which the government has ceased or is thinking about ceasing efforts to collect the tax owed. Tax priority may, in fact, encourage the government to rely less on so-called tax noncollection procedures prior to bankruptcy. Finally, removing tax priority may affect debtor behaviors in ways that may compromise the effectiveness of the government's tax collection efforts.

1. The Difficulty of Predicting Bankruptcy Risk

The machinery of tax collection is vast and complicated, and it encompasses various procedures, including procedures by which taxes are withheld, reported, and assessed; audits and investigations are conducted; property is lienied or levied upon; and judicial remedies are exercised by both government and taxpayers.²⁸⁸ For the most part, this machinery of tax collection churns forward without reference to or consideration of bankruptcy's impacts.²⁸⁹ This makes sense from a tax policy standpoint because the number of bankruptcy filers is likely to be relatively small and the government's information about the likelihood and timing of a taxpayer's bankruptcy filing is likely to be imperfect.²⁹⁰ From an *ex ante* standpoint, it is difficult to predict exactly if and when a taxpayer is going to file for bankruptcy.²⁹¹ Thus, it is not necessarily the case that increased bankruptcy risk alone will make the government more diligent.

Furthermore, there is, in fact, no completely risk-free way for the government to be less than fully enthusiastic in performing prebankruptcy tax collection because the debtor's other creditors may be able to capture the benefits of such laziness prior to bankruptcy, notwithstanding tax priority. In other words, in situations in which the government does not exercise its full collection powers prior to bankruptcy, this leaves room for private creditors and others to step in and capture any dollars that the government has left on the table, reducing the

²⁸⁸ See generally SALTZMAN & BOOK, *supra* note 154 (detailing IRS procedures). For a brief summary of some of these procedures, see Oei, *Social Insurance*, *supra* note 1, at 430–45.

²⁸⁹ See generally INTERNAL REVENUE SERV., *supra* note 67, pt. V (describing IRS collection processes).

²⁹⁰ For example, bankruptcy data show that for the calendar year 2012, there were a total of 1,221,091 bankruptcy filings (843,545 Chapter 7 filings; 10,361 Chapter 11 filings; and 366,532 Chapter 13 filings). *U.S. Bankruptcy Courts—Business and Nonbusiness Cases Commenced, by Chapter of the Bankruptcy Code, During the 12-Month Period Ending December 31, 2012*, U.S. COURTS 1, http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2012/1212_f2.pdf, archived at <http://perma.cc/RB2R-C2T7>. In comparison, for the 2011 tax year, there were approximately 145.6 million individual income tax returns filed. Jessica Holland & Michael Parisi, *Individual Income Tax Returns, Preliminary Data, 2011*, STATISTICS OF INCOME BULL., Winter 2013, at 4, 4, available at <http://www.irs.gov/pub/irs-soi/13inwinbulincomeprlim11.pdf>, archived at <http://perma.cc/Q4ZT-LLDX>.

²⁹¹ Furthermore, the government is not generally able to choose its debtors or alter its collection protocols on the basis of risk of taxpayer bankruptcy. Day, *supra* note 14, at 566; Hill, *supra* note 107, at 149; López-Ibor & Artés-Caselles, *supra* note 14, at 6.

assets available in bankruptcy and, correspondingly, the government's share of such assets.²⁹² Thus, although the government may choose to exercise restraint or forbearance on a prebankruptcy basis for other policy reasons, it is unlikely to do so merely on the grounds that tax priority offers sufficient protection.

2. Nonbankruptcy Considerations in Tax Administration Design

Bankruptcy is not the only consideration that affects the design of tax policy and tax collections. The government has other things to worry about, such as whether tax policy and administration are perceived as fair, whether the tax system collects sufficient revenue without causing excessive distortion or inefficiency, whether the systems of enforcement and monitoring that the government has put in place are too costly in relation to projected revenue gains, and whether it is harming taxpayers by enforcing compliance overzealously.²⁹³

For example, the government has long embraced an annual tax filing and assessment system. Thus, in the case of an individual taxpayer, the total amount of tax owed will not be known until that taxpayer files a tax return on April 15 (assuming no extensions are granted).²⁹⁴ Given that gross basis withholding is unlikely to perfectly reflect the amount of tax owed, the IRS may find itself in the position of being owed money come April 15, while being prevented by the annual filing and assessment system from beginning collection (or from having an effective tax lien) at an earlier point.²⁹⁵ One obvious way to prevent the sorts of collection and assessment delays that lead to nonpayment of taxes would be for the government to abandon the annual tax filing system and move to a real-time system where taxpayers have to pay taxes as income is earned.²⁹⁶ However, although this may help offset revenue losses from a repeal of priority, the feasibility of such an approach is still under review.²⁹⁷

Another example of how nonbankruptcy concerns come into play is the way the government uses the federal tax lien. The lien generally arises at the time of the tax assessment and continues until the tax liability is satisfied or the

²⁹² Of course, the bankruptcy trustee has the power to avoid certain prebankruptcy preferential transfers, provided certain statutory elements are met. 11 U.S.C. § 547 (2012). The Bankruptcy Code's provisions regarding fraudulent conveyances similarly limit the debtor's ability to transfer assets in the two years prior to the bankruptcy filing. *Id.* § 548.

²⁹³ See *supra* notes 247–248 and accompanying text.

²⁹⁴ 26 U.S.C. § 6072(a) (2012).

²⁹⁵ See *supra* note 56 and accompanying text (describing tax lien procedures).

²⁹⁶ Tax withholding and the requirement to make estimated tax payments are features that represent more “real time” approaches to tax collection. See *Estimated Taxes*, IRS, <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Estimated-Taxes>, archived at <http://perma.cc/5U62-S8V3> (last updated Sept. 3, 2013).

²⁹⁷ See Mike Godfrey, *IRS Advised to Identify Timeframe for ‘Real Time Tax,’* TAX-NEWS (June 6, 2013), http://www.tax-news.com/news/IRS_Advised_To_Identify_Timeframe_For_Real_Time_Tax_60969.html, archived at <http://perma.cc/BU8V-L89C>.

statute of limitations has run.²⁹⁸ Until the IRS has filed a NFTL, however, the lien will not have priority against purchasers, security interest holders, and certain other creditors.²⁹⁹ Thus, viewed from the point of view of protecting the IRS's interests over other creditors, the IRS has every incentive to file NFTLs as often and as liberally as possible. Actual IRS practice, though, suggests the existence of some self-imposed restrictions, limitations, and guidelines as to when a NFTL filing is appropriate. For example, the Internal Revenue Manual ("IRM") stipulates that the IRS has to meet certain conditions and requirements in order to file a NFTL³⁰⁰ and also specifies circumstances under which a NFTL should be filed and circumstances under which filing should not occur.³⁰¹ The IRS has also undertaken a lien-filing initiative that focuses on helping distressed taxpayers obtain a fresh financial start.³⁰² In circumscribing the circumstances under which a NFTL filing is appropriate, the tax law is juggling the interest in protecting the tax creditor against other certain other interests, including the impacts on the taxpayer and the need for due process.³⁰³ In sum, other tax policy considerations and goals suggest that even if priority is removed, we may not necessarily see the government turn to harsher collection strategies to make up the lost revenues.

3. Multiple Phases of Tax Collection (and Noncollection)

Finally, it is problematic to assume, as priority's critics do, a simplistic inverse relationship between the degree of tax priority and the level of commercial diligence exercised by the government. The government's response to the presence of priority is likely to depend on several factors such as how imminent bankruptcy appears to be, how much effort the government has already put into collection, how much success it has had in collecting other debts, and what stage it is at in the collection process.

An example of where a simple inverse relationship is unlikely to occur is where the IRS has already placed a taxpayer's account into "currently not collectible" ("CNC") status. In general, the IRS may remove a delinquent taxpayer's account from active inventory and place it into CNC status only after the required steps to collect have been taken.³⁰⁴ Delinquent accounts may be designated CNC for a variety of reasons, including—in the case of a corporation, ex-

²⁹⁸ 26 U.S.C. § 6322 (2012).

²⁹⁹ *Id.* § 6323(a), (f). Certain subsequently occurring interests are accorded a higher priority than the federal tax lien, even where a NFTL has been filed. *Id.* § 6323(b).

³⁰⁰ INTERNAL REVENUE SERV., *supra* note 67, § 5.12.2.3 (2013).

³⁰¹ *Id.* § 5.12.2.4.

³⁰² 1 TAXPAYER ADVOCATE SERV., 2012 ANNUAL REPORT TO CONGRESS 403 (2012).

³⁰³ *See, e.g., id.* at 348–51, 403–425 (discussing the IRS lien filing policy towards financially distressed taxpayers).

³⁰⁴ INTERNAL REVENUE SERV., *supra* note 67, § 5.16.1.1 (2011).

empt organization, or LLC—if the entity was liquidated in bankruptcy.³⁰⁵ In addition, a taxpayer who cannot afford to make monthly payments on a tax debt may request that the IRS place its account in CNC status.³⁰⁶ Once an account has been placed in CNC status, the IRS will discontinue collection efforts, though it will review collectability annually, and may assess interest and penalties.³⁰⁷ If the IRS has designated an account CNC, and has thus already effectively given up collecting on that account, it is unlikely that it will turn around and start collecting enthusiastically again if the taxpayer threatens to file for bankruptcy, even if tax priority is eliminated.

Another example of where the inverse relationship hypothesis breaks down is with respect to procedures by which the IRS chooses to forgive, forbear, or delay collection of tax debts—including the offer-in-compromise (“OIC”) procedure and the procedure for entering into installment payment agreements with taxpayers.³⁰⁸ I have argued in prior work that, like consumer bankruptcy, these tax noncollection procedures may satisfy the basic definition of social insurance in the sense that the government takes on the risk of taxpayer financial distress by delaying or declining collection in exchange for higher taxes and penalties (on present or future generations) or lower levels of public provision.³⁰⁹ The key difference between the insurance that happens in bankruptcy and nonbankruptcy forgiveness of tax debts is that bankruptcy transfers risk from consumer debtors to multiple creditors, whereas risk transfer via prebankruptcy tax noncollection transfers risk to only one creditor—the government.³¹⁰

Specifically, with respect to the OIC procedure, the IRS generally evaluates the financial acceptability of a taxpayer’s OIC application by considering the taxpayer’s financial situation and the potential for collection based on IRS guidelines contained in the IRM, which do not generally include consideration of bankruptcy outcomes.³¹¹ However, if the taxpayer indicates that she will file for

³⁰⁵ *Id.*; see also *id.* § 5.16.1.2.3 (2010). Such reasons also include corporate exemptions due to the classification of the organization, an inability to locate the taxpayer or the taxpayer’s assets, expiration of a statute of limitations, and the death of the taxpayer. *Id.* § 5.16.1.1.

³⁰⁶ *Id.* § 15.6.1 (describing the IRS protocol for CNC tax status). A taxpayer may do so by filing a Collection Information Statement, Form 433-A or 433-B. *Id.*

³⁰⁷ See *How to Receive CNC (Currently Not Collectible) Status from the IRS and Settle with the IRS*, PRLOG (Mar. 9, 2011), <http://www.prlog.org/11362739-how-to-receive-cnc-currently-not-collectible-status-from-the-irs-and-settle-with-the-irs.html>, archived at <http://perma.cc/HHJ5-DR5R>.

³⁰⁸ See generally Oei, *Offer-in-Compromise*, *supra* note 1 (analyzing policy justifications for the OIC procedure).

³⁰⁹ See generally Oei, *Social Insurance*, *supra* note 1 (describing tax forgiveness as social insurance).

³¹⁰ See *supra* notes 168–169 and accompanying text (summarizing literature regarding the social insurance function of bankruptcy). See generally Oei, *Social Insurance*, *supra* note 1 (comparing tax forgiveness to bankruptcy-related social insurance functions).

³¹¹ See INTERNAL REVENUE SERV., *supra* note 67, § 5.8.5.

bankruptcy if her OIC application is not accepted, the computation changes.³¹² In this situation, the IRS will assess whether the possibility of a bankruptcy filing really exists and the bankruptcy's projected impact on tax collection.³¹³ In determining the reasonable collection potential ("RCP") of the unpaid tax debt where bankruptcy is threatened, the IRS will analyze not only the collection information statement filed by the taxpayer, but also draft bankruptcy schedules; in addition, it will consider (1) whether the tax debts would be dischargeable in the bankruptcy and (2) whether the amount the taxpayer has offered equals or exceeds what the IRS would expect to recover in bankruptcy.³¹⁴ In other words, the IRS will consider the priority and dischargeability of the tax debt in evaluating RCP and the OIC, and, absent special circumstances, will not accept less in an OIC than it would get in a Chapter 7 bankruptcy.³¹⁵ As evidenced by IRM examples, the fact that a tax debt has priority and is nondischargeable may cause the amount of that tax to be included in computing what is reasonably collectible, potentially raising the RCP amount.³¹⁶ On the other hand, if the tax debt lacks priority and is dischargeable, the IRS may be more likely to consider and accept an offer that is less than what would normally be considered collectible, but nonetheless appears reasonable in light of bankruptcy's threat.³¹⁷

In sum, as the CNC and OIC examples demonstrate, once tax administration has entered the noncollection phase, the presence of priority³¹⁸ where a threat of bankruptcy has been made is actually likely to render the IRS less generous in accepting a taxpayer's offer to compromise a tax debt.³¹⁹ This outcome is directly contrary to that predicted by priority's critics.³²⁰ Thus, in this circumstance, the presence of priority and nondischargeability can be characterized as taking the pressure off the IRS to be overly generous in compromising a tax debt prior to bankruptcy, thereby curbing the amount of social insurance performed

³¹² See *id.* § 5.8.5.18 (2013); see also *id.* § 5.8.10.2.2 (2011) (discussing OICs before bankruptcy). If the taxpayer files for bankruptcy while an OIC is pending, the offer will be returned as nonprocessable because IRS policy is to not consider OICs while a taxpayer is in bankruptcy. See *id.* § 5.8.2.3.1 (2013); *id.* § 5.8.10.2.1 (2011); see also SALTZMAN & BOOK, *supra* note 154, ¶¶ 15.07[5]–.07[6][a] (describing the procedures for taxpayer submission and IRS evaluation of OICs).

³¹³ INTERNAL REVENUE SERV., *supra* note 67, § 5.8.10.2.2.

³¹⁴ *Id.* § 5.8.10.2.2.

³¹⁵ *Id.*

³¹⁶ *Id.* § 5.8.10.2.2.2 (providing examples).

³¹⁷ *Id.*

³¹⁸ Because the priority and nondischargeable taxes are to a large extent coextensive in consumer bankruptcy, and because the IRM guidelines are ambiguous, it is difficult to tease out whether it is the priority of tax debts or their nondischargeability that causes the IRS to so act. See *supra* notes 75–91 and accompanying text.

³¹⁹ See *supra* notes 304–317 and accompanying text.

³²⁰ Compare Morgan, *supra* note 14, at 467 & n.19 (citing 1 AUSTL. LAW REFORM COMM'N, *supra* note 128, ¶ 735), and INT'L MONETARY FUND, *supra* note 125, at 49, with *supra* notes 304–317 and accompanying text.

by the government in the shadow of bankruptcy.³²¹ Conversely, eliminating priority may incentivize the government to perform more prebankruptcy social insurance through procedures such as the OIC at the same time that priority itself also represents a greater social insurance burden for government in bankruptcy.

* * *

To summarize: The notion that the government is better able to diversify against debtor default risk than private creditors through forceful exercise of its superior enforcement powers needs to be critically examined. At a minimum, the effects of priority on tax enforcement and prebankruptcy tax forbearance need to be carefully studied before an informed decision can be made about the effects of priority's removal.

One last point must be noted: A key normative assumption underlying the case against tax priority is the idea that the government should be encouraged to collect taxes in an efficient and commercially reasonable manner.³²² However, it actually may not be such a terrible thing for the government to be slightly more generous to taxpayers who are genuinely financially distressed.³²³ From the standpoint of social insurance and smoothing of economic shocks, some forbearance in ordinary-course tax collection could be an affirmatively good thing.³²⁴ As previously noted, the economics literature has recognized that under certain conditions, the government can act as a social insurer or lender of last resort to taxpayers by allowing some tax avoidance.³²⁵ Thus, even if it is true that the government is not exercising maximum diligence in collecting taxes because of the priority it enjoys in bankruptcy, whether or not this is normatively problematic is open to question.

C. Increased Risk-Taking by Debtors and Other Creditors

Finally, tax priority serves as an important structural safeguard against overly risky debtor and private creditor behaviors. This is true both in situations where the taxpayer files for bankruptcy and in the ordinary course. As is the case

³²¹ Cf. Hayashi, *supra* note 198 (manuscript at 46–47) (raising concerns that heterogeneity in legal salience regarding the property tax appeals system may shift the burden of property taxes to taxpayers in certain demographic groups). See generally Oei, *Social Insurance*, *supra* note 1 (describing the prebankruptcy social insurance function of tax forgiveness).

³²² See *supra* notes 123–127, 155–156 and accompanying text.

³²³ The trick, of course, is in determining which taxpayers are genuinely financially distressed. See Bryan T. Camp, *The Failure of Adversarial Process in the Administrative State*, 84 IND. L.J. 57, 73–77 (2009) (making a conceptual distinction between taxpayers who “can’t pay” and those who “won’t pay”).

³²⁴ See generally Oei, *Social Insurance*, *supra* note 1.

³²⁵ See Andreoni, *supra* note 114, at 44; Andreoni, *supra* note 115, at 144–45; Hayashi, *supra* note 198 (manuscript at 36–37); Oei, *Social Insurance*, *supra* note 1, at 485.

with the tax noncollection procedures, it is likely that the greater the amount of risk assumed by the tax creditor in bankruptcy (i.e., by eliminating tax priority), the greater the amount of risk it will be forced to assume prior to bankruptcy. The converse is also true. This Section explores the impact of tax priority on government and debtor prebankruptcy behaviors as well as its impact on the behavior of other creditors.

1. The Impact of Tax Priority on Taxpayer and Government Prebankruptcy Behaviors

Many of the arguments against tax priority ignore the impacts that the elimination of tax priority may have on the tax planning behaviors of nonbankrupt taxpayers.³²⁶ In fact, it is possible that removal of tax priority may cause taxpayers to enter into more aggressive prebankruptcy tax nonpayment behaviors that may reduce the pool of tax revenues beyond those directly attributable to an elimination of priority.³²⁷

Removal of preferred treatment for tax claims may reduce the pool of revenues collected from otherwise compliant taxpayers through a number of pathways:

a. Lower Levels of Compliance Due to Reduced Cost of Nonpayment

First, removing tax priority (assuming these taxes will then be dischargeable) essentially reduces the costs of tax nonpayment, thereby increasing the degree of noncompliance among taxpayers. Any insurance scheme raises the problem of moral hazard, and the greater the amount of insurance coverage, the bigger the moral hazard. Thus, an expanded social insurance role for the government in bankruptcy might be expected to generate more risky behaviors by taxpayers ahead of bankruptcy.

How might these risky behaviors manifest? One is likely to see taxpayers engage in tax minimization or nonpayment behaviors, take more aggressive positions in filing tax returns, choose tax strategies based on the expected payoff balanced against the costs of failing to pay, and shop for ways to use lower tax jurisdictions to structure tax minimization strategies.³²⁸ Priority's removal also makes it less expensive for a taxpayer to "sell" the government's share of the

³²⁶ See *supra* notes 119–133 and accompanying text (providing a brief overview of arguments against tax priority).

³²⁷ This analysis assumes that tax debts denied priority would also become dischargeable.

³²⁸ Cf. H.R. REP. NO. 95-595, at 190 (1977) ("An open-ended dischargeability policy would provide an opportunity for tax evasion through bankruptcy, by permitting discharge of tax debts before a taxing authority has an opportunity to collect any taxes due."). Scholars have long recognized that in this way, priority may help prevent bankruptcy from serving as a tax shelter through which taxpayers can escape paying their tax debts. See, e.g., *id.*; Williams, *Rethinking Bankruptcy and Tax Policy*, *supra* note 14, at 196; Williams, *NBRC Tax Recommendations*, *supra* note 14, at 52.

taxpayer's assets to other lenders prior to bankruptcy by taking on more borrowing, or to use trust fund taxes as an additional line of credit. This is because the amount of tax owed that will need to be repaid in and after bankruptcy will be smaller, particularly if the tax debt is dischargeable.³²⁹ Increased use of leverage may itself lead to an uptick in bankruptcy filings. In short, once non-compliance costs less, we can expect taxpayers to find more aggressive ways to circumvent their tax payment obligations.

b. Increased Noncompliance Due to Changes in Government Behavior

Elimination of tax priority (again, assuming that taxes then become dischargeable like other debts) may also cause changes in the government's tax administration behavior that consequently lead to an increase in tax avoidance. If it is true—as priority's critics suggest—that eliminating tax priority may cause the government to enforce collection more forcefully (a claim that this Article has critiqued), then it is possible that more aggressive exercise of the government's collection powers may actually lead to an increase in tax evasion.³³⁰ In fact, the possibility of this outcome is suggested by a growing body of literature.³³¹ Thus, it is possible that more aggressive action by the government could in fact lead to less taxpayer compliance.

c. Impacts on Taxpayer Morale

Finally, elimination of tax priority may lead to decreased tax collections due to impacts on taxpayer morale and propensity to comply.³³² The literature suggests that the perceived level of tax evasion by other taxpayers is one of the factors that can cause taxpayers to be less likely to comply with their own tax obligations.³³³ An elimination of tax priority would result in bankrupt taxpayers paying less money to the government, which could lower morale and compliance among compliant taxpayers.³³⁴

³²⁹ See Bebachuk & Fried, *Uneasy Case*, *supra* note 70, at 873 (explaining borrower misbehavior as a result of the fact that “[t]he objective of a firm's owners—maximization of the expected return from their investment in the firm—does not take into account the effect of the firm's activities on its creditors”).

³³⁰ See James Andreoni et al., *Tax Compliance*, 36 J. ECON. LIT. 818, 841–46 (1998) (summarizing studies of tax compliance); John Cullis et al., “*Spite Effects*” in *Tax Evasion Experiments*, 41 J. SOCIO-ECON. 418, 422–23 (2012) (illustrating that increased audit rate and penalties may lead to higher levels of evasion).

³³¹ See, e.g., Andreoni et al, *supra* note 330, at 841–46; Cullis et al, *supra* note 330, at 422–23.

³³² See Andreoni et al, *supra* note 330, at 841–46; Cullis et al, *supra* note 330, at 422–23; see also Molero & Pujol, *supra* note 243, at 158–59 (finding that the suspected level of other people's tax evasion is a justification for tax evasion).

³³³ See Molero & Pujol, *supra* note 243, at 158–59.

³³⁴ See *id.*

2. The Impact of Priority on Prebankruptcy Behaviors of Other Creditors

If priority for tax debts is eliminated, this will effectively lower the amount of risk other unsecured creditors are required to undertake in the bankruptcy.³³⁵ The expected effect of private creditor risk reduction will be to make borrowing cheaper by lowering interest rates and/or increasing the supply of credit.³³⁶ Greater availability of credit and/or cheaper rates are likely to result in more borrowing by debtors, which may increase default rates and bankruptcy filings.³³⁷ Conversely, the existence of tax priority can reign in credit and borrowing, thereby safeguarding against debtor overleverage and minimizing default risk.

Finally, it is possible that eliminating tax priority may discourage monitoring by private creditors.³³⁸ When private parties engage in lending transactions, a typical agreement requires representations by the borrower that it has paid its tax liabilities. Creditors have an incentive to monitor tax compliance by borrowers because unpaid tax liabilities reduce the likelihood of repayment to such creditors (for example, because significant unpaid taxes may signal poor financial health or an impending default). Thus, the government may benefit from such monitoring to the extent that monitoring increases tax collections.

Tax priority may lead to more careful monitoring because the existence of unpaid priority taxes will decrease an unsecured private creditor's payout in bankruptcy.³³⁹ Conversely, elimination of tax priority may cause private creditors to monitor less closely, because nonpriority taxes are less costly to a private creditor if left unpaid prior to bankruptcy.³⁴⁰ Thus, a possible effect of eliminating tax priority is that the government may lose some of the benefits of private creditor monitoring.

* * *

In sum, the impacts of eliminating tax priority on the debtor's tax planning behaviors and the lending behaviors of other creditors need to be studied further. The central point is that whereas commentators have argued that the amount of tax revenues lost in bankruptcy itself from a removal of priority is relatively

³³⁵ See *supra* notes 200–209 and accompanying text (describing tax priority's effect on the risk allocation aspect of bankruptcy's social insurance function).

³³⁶ Cf. Day, *supra* note 14, at 567 (noting that priorities "can impact the cost and availability of credit, which will increase as funds available for distribution to other creditors decrease").

³³⁷ Cf. Bebchuk & Fried, *Uneasy Case*, *supra* note 70, at 873. Increased borrowing is also likely to lead to increased interest deductions being taken by business taxpayers, which could reduce the amount of taxes collected even further. See 26 U.S.C. § 163 (2012) (allowing, generally, a tax deduction for certain interest paid or accrued on indebtedness within a taxable year).

³³⁸ See Hill, *supra* note 107, at 179 (noting that giving priority to nonconsensual creditors "would reinforce incentives for consensual creditors to monitor the debtor's activities").

³³⁹ See *supra* notes 25–52 and accompanying text (describing the effects of priority and providing a simple example).

³⁴⁰ See Hill, *supra* note 107, at 169–70.

small (or at least, was small in the past),³⁴¹ this analysis has not taken into account the revenue losses that may stem from more aggressive tax avoidance behavior, debtor overleveraging, or changes in creditor behavior. These effects, which have received insufficient scholarly attention, may lead to increased bankruptcy filings, increased unpaid debts in bankruptcy, and revenue losses from increased risk-taking in the ordinary course. Merely focusing on the losses directly related to tax priority's elimination yields an incomplete picture of the overall effects of priority and its absence on revenues. To be clear, this Article does not claim that all of these impacts will necessarily come to pass. The point is that priority's critics have not even addressed or evaluated the potential magnitude of these impacts—so we simply do not know the effects that priority's removal will have on the behaviors of the general pool of taxpayers with respect to compliance, tax planning, and tax evasion, and on other creditors in terms of extension of credit.

CONCLUSION

This Article has argued that priority for tax debts in bankruptcy is defensible in light of the government's overall risk-bearing and public provision functions and in light of constraints on the government's ability to protect itself against debtor default risk. Critics of tax priority tend to characterize the government as the ultimate risk spreader, able to diversify across a large pool of debtors, and able to use its strong tax administration powers to defend its interests against defaulting taxpayers. This Article has questioned those assumptions by highlighting some of the realities of tax policymaking and tax administration and by pointing out the formal and informal limitations on the government's ability to diversify against risk. Furthermore, this Article has noted that one of the key reasons for retaining tax priority is that priority may be a safeguard against revenue-threatening behaviors of debtors, private creditors, and the government *outside of* bankruptcy. This point has not been sufficiently appreciated in the literature.

Ultimately, this Article has argued that, in light of the government's important social insurance and public provision functions, a rule that exposes the government to less debtor default risk in bankruptcy than private unsecured creditors is the better rule. Although raising revenue through taxation generally can be expected to have an efficiency cost, this may be unavoidable in the bank-

³⁴¹ See López-Ibor & Artés-Caselles, *supra* note 14, at 12–13, 16; see also 1 AUSTL. LAW REFORM COMM'N, *supra* note 128, ¶ 735 (“The net loss to the Commissioner from the abolition of the priority would be insignificant.”); Williams, *NBRC Tax Recommendations*, *supra* note 14, at 51 (“There can be no doubt today that whatever amount the government is able to collect as a result of such a priority over what it would receive without it is insignificant” (quoting Marsh, *supra* note 14, at 729)).

ruptcy context in light of limitations on the government's ability to diversify against risk while performing its social insurance and public provision functions.

The case for tax priority presented here is necessarily limited because the precise impacts of eliminating tax priority have not, for the most part, been determined empirically. Such a task is beyond the scope of this Article. This Article's key point is that the debate over tax priority needs to be analyzed as a tax policy and tax compliance issue, not just a bankruptcy policy issue. In calling for tax priority's elimination, detractors have largely neglected or mischaracterized the realities of tax policy and administration. In short, considered investigation and analysis ought to be undertaken before the arguments against tax priority can be taken seriously.

This Article has also not taken a specific position regarding precisely which taxes should have priority or which priority rank the tax creditor should enjoy. Rather, this Article's main concern has been to caution against further reductions in, or elimination of, tax priority, as recommended by the efficiency and diversification arguments against priority. Such reductions might take the form of narrowing the scope of the types of taxes granted priority, promoting other creditors above the priority taxes (which currently rank eighth), or eliminating priorities altogether. If anything, when considered in tandem with the government's non-bankruptcy risk absorption and public provision functions, the priority awarded to the tax creditor should probably be strengthened.

Finally, although this Article has focused on the tax priority question in the United States bankruptcy context, the analysis undertaken here can serve as a blueprint for how to analyze tax priority questions in the context of other countries and economies. Specifically, the tax policy and tax compliance insights presented in this Article, as well as the overall analysis of relative risk burden and government functioning contained herein, should be instructive in formulating law and policy regarding tax priority in any national context.